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Section 1
Global Business & Regional Issues

Implications of Refreshed Regional Economic Integration for the WTO

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Abstract:

Globalization and regional integration constitute the two main trends of the world economy today. Since the mid 1980s, Regional Trade Agreements(RTAs) have proliferated at an unprecedented rate throughout the world. Against this backdrop, it makes sense to explore the nature of the refreshed regionalism and its implications for the multilateral trading system. Based on the "Doha Declaration", we further explored the way WTO can face itself with the opportunities and challenges brought about by the refreshed regional integration. The analysis dwells upon provisions at both the multilateral and the regional level, including some matter-of-fact demonstration. It seems to us that multilateralism and regionalism enjoy a symbiotic relationship academically and practically. We concluded by suggesting that the multilateral trading system should compete with and benefit from regional initiatives. Since the 1980s, globalization and regional economic integration have become the two main trends of the development of the world economy and trade. On the one hand, the establishment and operation of WTO has advanced economic globalization in depth; on the other hand, regional economic blocs of all sorts are booming all over the world, setting the stage for the most dramatic episode of regional economic integration the world has ever seen.

1. New development of regional economic integration since 1990s

During this period, the development of regional economic integration has been taking on many new characters. Not only the number of regional trade agreements (RTAs) has increased exponentially, but their scope and geographical reach have broadened and expanded as well; and the mechanism of RTAs has diversified.

1.1 The proliferation of RTAs has developed at an unprecedented rate all over the world.

As of March 2002, 255 RTAs had been notified to the GATT/WTO, of which 173 are currently in force (see Fig.1).

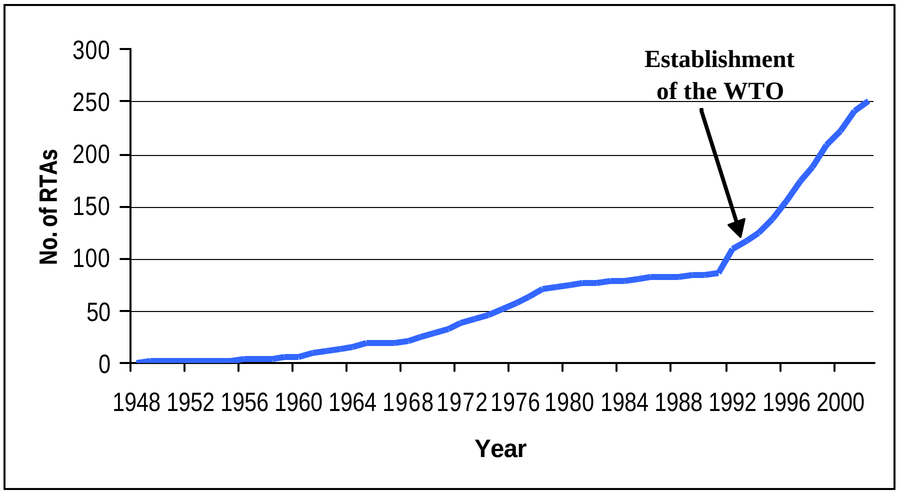

FIG 1: RTAS NOTIFIED TO THE GATT/WTO (1948-2002), CUMULATIVE
Source: "Regional Trade Integration under Transformation", WTO Secretariat, Feb., 2002

Among those RTAs in force, the bilateral free trade agreement signed by two parties (sovereignties or regional economic organizations), has surged in number and became the most common type of RTAs. The most successful example is the United States-Israel Free Trade Agreement reached in 1985.

1.2 New generation RTAs consist of members that may be geographically dispersed, staying in different stages of development and trade liberalization, and/or adopting various trading patterns.

The network of RTAs spanned within and across continents. For example, the Asia-Pacific Economic Cooperation (APEC) currently has 21 members across Asia, Oceania, North America and South America.

Also, RTAs consist of countries with different social systems or of different development levels. In America, the North America Free Trade Agreement (NAFTA) was founded by United States, Canada and Mexico, which stay in different developing stages, giving rise to a strong and positive rise in trade and investment within member economies and further influencing other countries in Latin America, namely Chile and Caribbean countries; in Asia, despite different social systems, ASEAN accepted Vietnam, Kampuchea and Burma as new members, aiming for a coordinated development within the Eastern Asia.

1.3 Many sub-regional preferential agreements have emerged, rendering the distribution of RTAs even more complex.

Consequently, a single country often has an overlapped membership, reflecting a policy mix adopted by the government. In other words, many countries have fostered flexible trade policies, emphasizing multilateral trading system and RTAs at the same time. For instance, Mexico not only joined NAFTA and LAIA, but also signed the bilateral free trade agreement with EFTA and most Asian countries.

1.4 There are two directions in the new development of RTAs.

First, following the exclusive logic, EU continues moving toward further enlargement and its intra-region cooperation is deepened and strengthened steadily. By the time when Poland.Czech and other 10 countries finished their entry in May 2004, the number of EU members will sum to 25, approaching its final goal of a "Large Europe".

Second, there came new-pattern RTAs of which APEC is a major representative. APEC is well-known for its persistent advocating of "Open Regionalism", which is characterized by unilateral, non-discriminating liberalization, openness to new members and the informal, non-institutional, and voluntary execution procedure. During the period between 1980 and 1992, trade linkages between APEC's Asian and non-Asian members strengthened considerably. As a result, the share of intra-APEC trade in total APEC trade volume climbed from about 58 percent in 1980 to about 70 percent in 1992.

1.5 In the light of the rapid development of science and technology, RTAs established various trade-related provisions going beyond traditional tariff reduction or elimination.

For example, the "new-generation" RTAs recently concluded or currently under negotiation has showed their ability of harnessing new technologies in developing approaches for risk management so as to facilitate the clearance of low-risk goods with minimal or no documentary verification and physical inspection.

2. Momentums of the new development of RTAs

2.1 Economic globalization facilitates the flow of commerce, technology and investment all over the world, which in turn promotes regional integration.

After the Cold War, international connection in production, trade and finance has strengthened with less political counterwork. And the globalization is accompanied by increasingly fierce competition. To consolidate their advantageous status in the world market, developed countries club together by institutionalizing themselves into RTAs. Meanwhile, developing countries also take deliberate steps to enter into RTAs in order to enhance their economic growth and increase their participation in international trading system.

Besides, economic globalization also calls for a harmonious cooperation among countries of different social systems and/or at different developing levels. Consequently, RTAs adjust themselves actively by drawing on new members, allying with other regional organizations, forming new RTAs or deepening existing ones. All these lead to diverse forms of RTAs.

2.2 In the late 1990s, the multilateral trade liberalization process had stagnated due to the pending of Uruguay Round negotiation, which in turn inspired worldwide enthusiasm for regionalism.

The pace of the course of the multilateral trading system is influenced by the fluctuation of world economy and the economic development cycle of each member country. During the 1980s and early 1990s, and from the late 1990s up to now, the slow pace of economic development combined with prevailing trade protectionism decelerated the process of multilateral trading system. Against this backdrop, each country attaches more importance to regional economic cooperation so as to share the fruit of regional liberalization and hedge against the uncertainties in the global economic environment.

2.3 RTAs had come into being before the establishment of GATT.

At the very start, GATT took a supportive stand towards RTAs due to the rooted benefits some GATT parties had in regional trade arrangements before its conclusion. Under the GATT/WTO, members are allowed to further market access they bound in the GATT/WTO by concluding RTAs, albeit subject to some criteria contained in GATT Article XXIV, GATS Article V and "Enabling Clause". For example, it is stipulated that "the purpose of a customs union or of a free-trade area should be to facilitate trade between the constituent territories and not to raise barriers to the trade of other contracting parties with such territories". And "Enabling Clause" agreed in Tokyo Round entitled developing countries to sign a favorable agreement of merchandise trade.

Note that, as implied in GATT Article XXIV 4, WTO hopes to balance regional integration goal with multilateral liberalization goals by formulating rules on regional economic integration (Joel P.Trachtman, 2002). In other words, RTAs are expected to pursue development strategies within the framework of global multilateral trading system.

2.4 Whereas WTO's regulations concerning RTAs have inborn deficiencies, countries had the access to various RTAs while bypassing WTO restrictions.

This point will be elaborated in following section.

2.5 The trade policy conversion of major traders is an important propellant.

In the late 1980s, large traders, such as the United States, Japan and Canada transferred their strategy and policy one after another from emphasizing multilateral trade liberalization to combining multilateral agenda with regional initiatives. This trend of policy conversion in turn influenced the trade policy of other countries and finally promoted the process of regional economic integration.

3. Implications for WTO

3.1 Refreshed regionalism opens some opportunities for the multilateral trading system.

3.1.1 RTAs share some goals of trade liberalization with WTO.

Regional liberalization efforts assist in WTO's goal of reducing trade barriers worldwide to the extent that RTAs set out to remove various trade blocks that hinder free flowing of goods, service and production factors within the region. And the new development of RTAs has reinforced this consistency between regional and multilateral goals in the following two aspects. One is that new-pattern RTAs, APEC to be specific, have put ever-increasing emphasis on "Open Regionalism" with an ultimate goal of global trade liberalization based on liberalizing efforts in the Asian-Pacific Area. The other is the "parallel processing" conducted by WTO and RTAs against the non-tariff trade barriers that excessively burden international trade. For instance, the technical barriers to trade and the sanitary and phytosanitary issues (collectively "TBTSPS" provisions) are addressed through "positive integration" (i.e. the "legislation" of harmonized rule or rules of mutual recognition) and "negative integration" (i.e. judicially-applied standards with the effect of striking down national regulation, such as national treatment, necessity or balance rules.) at regional level. The former results in lower cost incurred to foreign producers, while the latter works by forcing RTA members to take into account the cost to foreign producers in formulating their TBTSPS measures. This "RTA-driven 'autonomous' TBTSPS liberation", as named by Joel P Trachtman [i], is bound to enhance the multilateral trade liberalization.

3.1.2. The internal consensus of RTAs may aid in the conclusion of multilateral negotiations.

The constitutive base RTAs rest on has been expanded and deepened since the 1980s, rendering an even more extensive connection of interests on the base of which more countries are to cooperate in trade liberalization. Such a growing membership of individual RTAs means, instead of being conducted by over 100 countries, multilateral negotiations are actually led by several powerful country groups. On the other hand, extensive common interests within a RTA ensure ever-concerted action taken by its member countries. As a result, it matters a lot to the multilateral negotiation progress whether some major regional country groups can reach an agreement on certain issues. A good example will be the advent of NAFTA and APEC favoring significant progress in the negotiation between U.S.A, Canada, Japan and EU (EC before 1992), and ultimately leading to the conclusion of the marathon negotiation of the Uruguay Round at the end of 1993.

3.1.3 RTAs are key laboratories for the development and the learning-by-doing of new paradigms in the design and implementation of trade policies at the multilateral level [ii].

Regional agreements are based on reciprocity principles involving a smaller group of countries, which provides a better environment to reach consensus on the complex range of issues in modern trade agenda, to better evaluate the potential gains from the bargain, and to gain private sector understanding and support for the liberalization process [iii]. Deepened liberalization, as well as liberalizing measures concerning modern trading issues, can often be observed in RTAs. To cite an example, it took WTO almost ten years to schedule multilateral negotiations on the Singapore issues (i.e. investment, competition & trade facilitation issues) since it first placed them on the multilateral trade agenda during the Uruguay Round [iv].

On the other hand, although the regional pace of rules development with respect to these issues also began to accelerate during the 1990s, various RTAs have moved further and faster in making specific rules concerning these issues so far. Key Heydon (2002) pointed out that in each of the three areas there is evidence of provisions in RTAs going beyond those in the WTO. He cited electronic data interchange as an essential feature in Japan-Singapore Economic Partnership Agreement (JSEPA) to demonstrate that RTA negotiations has paid special attention to electronic commerce and the increase use of information & communication technologies. He concluded that the effects the patchwork of RTAs can have on non-members and on the process of dispute settlement, potential and real, can be seen as contributing to the case for a strengthened multilateral framework [v].

3.2 The proliferation of regional integration poses challenges to the multilateral trading system led by WTO.

3.2.1 Opportunities imply challenges.

3.2.1.1 RTAs may obstacle worldwide trade liberation when pursuing regional goals.

Discriminating treatment between members and non-members characterizes conventional RTAs, which will inevitably lead to the deviation of regional liberalizing progress from the multilateral goal. The new development of RTAs made this discrepancy even more complicated.

A typical example for this will be the "preferential rules of origin' implemented by RTAs. For RTAs with a discriminatory nature where parties grant each other preferential market access but have not yet harmonize their treatment for goods imported from third countries, rules of origin (RoOs) is necessary for determining whether such a good is eligible for preferential treatment in the importing country. However, diverse RoOs developed by various RTAs result in a lack of uniformity in preferential rules of origin worldwide. Also, the increased overlapping membership of RTAs means the coexistence of different RoOs in a single county. The considerable complexity of these roOs, added their often insufficient transparency, can "generate important administrative and operational costs" for the government, and burden producers with the work to acquaint with them and meeting the requirements [vi]. Some economists argue that the frequent use of preferential RoOs may compromise the established preferences under the RTA, causing potential inefficiencies in resource allocation [vii]; it may also increase the possibility of trade (or investment) diversion [viii].

Trade diversion (i.e. to promote intra-RTA trade at the expense of imports from outside the RTA) is often cited by economist to illustrate the conflict between regional and multilateral liberalization goals. The evidence for this empirical question is represented in Table 1which lists the proportion of intra-RTA trade in total export of RTAs. As the data show, the intra-RTA trade of some influential RTAs, such as EU, FTAA and APEC, has accounted for over a half of their total export. Besides, NAFTA, FTAA and APEC all see a striking rise in intra-RTA after their birth in the1990s.

TABLE 1: THE INTRA-RTA TRADE IN TOTAL EXPORT

Region	Group	Year of Founding	Intra-RTA Trade in Total Export of the Group (%)					
			1980	1990	1995	1999	2000	2001
Europe	EU (EC)	1957	60.8	65.9	62.4	63.3	62.1	61.2
America	FTAA	1994	43.4	46.6	52.5	60.0	60.8	60.1
	MERCOSUR	1994	11.6	8.9	20.3	20.6	20.7	20.8
	NAFTA	1994	33.6	41.4	46.2	54.6	55.7	54.8
Africa	UEMOA	1994	9.9	12.1	10.3	13.1	13.0	13.5
Asia	ASEAN	1967	17.4	19.0	24.6	21.7	23.0	22.4
	GCC	1981	3.0	8.0	6.8	6.7	5.0	5.1
Interregional	APEC	1989	57.9	68.4	71.8	71.8	73.1	72.5
	BSEC	1992	5.9	4.2	18.1	13.6	14.2	14.8

Source: UNCTAD Handbook of Statistics (2002)

3.2.1.2 Regional country groups as a whole are reluctant to compromise in multilateral negotiations.

The independence of a RTA member is limited by its membership in the RTA. The overlaps of membership confront a single country with entangled interests, thus make it tend to take a relatively conservative stand in multilateral negotiations. Besides, major RTAs are equivalent in power. Once the bargain on sensitive trade issues between them comes to a deadlock, so will multilateral negotiations, as illustrated by the lingering conclusion of Uruguay Round and the tortuous startup of the Doha Round.

3.2.1.3 Prosperous regional "laboratories" may hinder multilateral liberalization process, and distract people's attention from multilateral trading system.

For one thing, "laboratories" serve as examples or pathfinders for future multilateral practice, some of them may pre-determine the path of multilateral integration [ix]. This kind of path dependence may enable some RTAs to take advantage of "first mover" status and will finally give rise to an imbalance in multilateral trading system. Also, it is hard to choose among or to harmonize several distinct proven regional disciplines.

On the other hand, RTAs are often made possible and successful under specific regional circumstances which significantly differ from the global condition applying in the WTO. In other words, associated with a complex set of region-specific factors [x], measures proven in "laboratories" cannot always be adopted in multilateral trading system. Some RTAs even have had intra-RTA cooperation go beyond economic issues to include political coordination, exceeding the globalization process both in scope and in depth. Attracted by welfare gains at the regional level, a country may focused on liberalizing arrangements within the region, while became more conservative in multilateral negotiations.

3.2.2 In face of the refreshed regionalism, existing WTO rules concerning RTAs are even more problematic.

As implied in GATT Article XXIV 4, WTO hopes to balance regional integration goal with multilateral liberalization goals (Joel P.Trachtman, 2002). In order to achieve that, it laid out RTA-related rules in GATT 1994 Article XXIV (including the Understanding on The Interpretation of Article XXIV of the GATT 1994, i.e. the "Understanding"), GATS and "Enabling Clause". And Committee on Regional Trade Agreements was established in 1996 to take care of RTA-related issues. Despite all these efforts, WTO's accommodation to the RTAs is still open to question, in light of which WTO has designated rules concerning RTAs as one of the WTO rules to be discussed in Doha Round.

3.2.2.1 The definition of RTAs stated in WTO rules is too narrow to reflect the diversity of existing RTAs.

GATT Article XXIV (including the "Understanding"), GATS and "Enabling Clause" refer to RTAs in two forms: customs union and free-trade area, leaving a gap between the forms of RTAs being ruled and those of RTAs currently in force.

3.2.2.2 WTO rules ruling the formation of RTAs are ambiguous in expression and unclear in definition, causing many disputes in practice.

Of the 255 RTAs notified to the GATT/WTO [xi] up to March, 2002, most agreements are notified under GATT Article XXIV and/or GATS Article V (as showed in Fig. 2), reflecting the important status of these two articles. Notwithstanding, they are still problematic in practice and even more awkward in ruling modern RTAs.

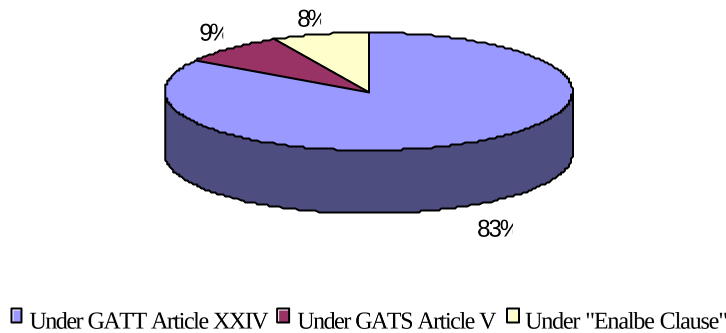

FIG.2: RTAS NOTIFIED TO WTO UP TO MARCH, 2002 (BY RELATED WTO PROVISIONS)
Source: WTO, "Report (2002) of the Committee on Regional Trade Agreements"

3.2.2.2.1 Some key words in GATT Article XXIV are ambiguous in meaning.

In Article XXIV: 8, the phrase "substantially all the trade" does not have any straightforward definition, nor does it set any specific criteria for judgments. As a result, its application is open to dispute. First, members hold different stands on whether "substantially all the trade" should be measured on the basis of quantity (i.e. the proportion in total trade volume) or quality (i.e. the inclusion of key industrial sector). Second, this phrase is often associated with restrictive rules of origin, that is, the adoption of preferential RoOs by RTAs may affect the assessment involved in this requirement. Third, once RTA members impose restrictive measures in light of the exception clause in Article XXIV: 8, the intra-region trade volume will inevitably change, which in turn will play a role on in the satisfaction of the requirement of "substantially all the trade".

And the definition of "other restrictive regulations of commerce" in Article XXIV: 5 is no more clear than that of "other regulations of commerce" in Article XXIV: 8. Besides, neither has distinguished policies applying to member countries and those to non-members. Meanwhile, as stated in Article XXIV: 7, "promptly notify" signals little cues about the specific notification time required, to some extent discouraging RTA members from notifying timely.

3.2.2.2.2 The problems with GATS V are just the extension of those with GATT Article XXIV.

The controversy on the phrase "substantial sectoral coverage" and "substantially all discrimination" in GATS Article: 1 include whether to quantify the standards for "substantially all discrimination", and which gauge, sectoral, sub-sectoral, or service property, the assessment of "substantial sectoral coverage" should be based on , and how to make sure that "substantially all discrimination" has been deduced or eliminated, etc.

3.2.2.3 Existing WTO rules are far from effective in regulating multifarious trade and investment measures taken by RTAs.

Apart from ambiguous reference in GATT Article XXIV: 8, there are no specific regulations concerning RoOs, TBTSPS, anti-dumping measures, or security measures adopted by RTAs. And current WTO provisions about the review of RTAs DO NOT cover investment issues, even though RTAs have increasingly covered them. WTO does have reached multilateral agreements on these issues respectively. However, the relationship between GATT Article XXIV and the special agreements, or the exception from obligations contained in the special agreements provided by GATT Article XXIV to RTAs, have not yet been explained and certified clearly. Thus what happens where Article XXIV permits what those other agreements prohibit? This could come up in many disputes among member and non-member countries, only to be settled one by one as individual cases.

It is important to note that the "Agreement on Rules of Origin" under WTO establishes disciplines only on RoOs which "are not related to contractual or autonomous trade regimes leading to the granting of tariff preferences going beyond the application of paragraph 1 of Article I of GATT 1994", often referred to as "MFN rules of origin". Apart from the Declaration in Annex II to this agreement where Members commit to ensure transparent administration of the origin rules related to the implementation of their preferential schemes, there are no multilaterally-agreed disciplines on RTA preferential RoOs [xii].

3.2.2.4 CRTA cannot function well enough so far.

Examination of the consistency of individual RTA with WTO regulations bottlenecks the full function of CRTA. The progress made by CRTA in its examination is listed in Table 2 below. The figures suggest that CRTA is occupied with factual inquiries and clarifications, but after that, it fails to draw a conclusion on whether the RTA in question is complied with the WTO requirements. As a result, by the end of 2002, CRTA still had to report that "NO progress was made…on the completion of the examination reports". Ambiguous WTO rules, members' reluctance to submit detailed data, and the complexity of RTAs are responsible for this.

TABLE 2.RTAS' STATUS IN THE EXAMINATION PROCESS IN CRTA (UP TO OCT. 2002)

Examination stage	**Number of RTAs**
Factual examination not started	22
Under factual examination	27
Factual examination concluded	76
Examination report concluded	0
Total	125

Source: "Report (2002) of the Committee on Regional Trade Agreements"

The review process drags on also due to late submission of RTAs' reports. RTA members are required by the "Understanding" to submit reports on a periodical basis explaining the implementation of the RTA. In 1998, CRTA suggests a two-year period basis which was accepted by the Council for Trade in Goods, the Council for Trade in Services, and the Committee on Trade and Development. Since 1999, CRTA has announced once a year the list of members required to submit the report during that year. However, not all members in the list can fulfill its responsibility. For example, all of the 11 reports considered by the CRTA at its Thirty-Third Session in 2002 were included in the list for 2001 and due to be reviewed during that year.

4. How will WTO face itself with the RTA proliferation?

4.1 To perfect existing WTO rules applying to RTAs.

In "Doha Declaration", ministers called for renegotiation on this field "aimed at clarifying and improving disciplines and procedures under the existing WTO provisions applying to regional trade agreements." The task may deal with two aspects.

4.1.1 To seek disciplinary betterment.

4.1.1.1 To clarify the wording of WTO rules.

It is necessary to establish a set of clear, consistent, and easy-to-operate criteria for the assessment of "substantially all trade", "substantial sectoral coverage", and for the specific forms of "other restrictive regulations of commerce" and "other regulations of commerce". And some plausible methods are also to be determined to indicate the elimination or deduction of restrictions and discrimination in RTAs required by WTO.

4.1.1.2 To strengthened the binding power of RTA-related WTO rules.

One way to achieve this goal is to enlarge the definition of forms of RTAs to include diverse forms of today's RTAs. The other way may be to accommodate complicated RTA trade and investment measures by formulating specific WTO disciplines with respect to RoOs, anti-dumping measures, safeguards and investment rules adopted by RTAs.

4.1.1.3 To explain the relationship of GATT Article XXIV, GATS Article V with other agreements and the "Enabling Clause" under WTO.

As for this task, precedent cases in dispute settlement need to be considered to make the final decision. For instance, Joel Trachtman (2002) consulted the decisions of the Appellate Body in the cases of EC-Bananas III, Canada-Periodicals, Indonesia-Automobiles, US-Line Pipe, and Korea-Dairy Safeguards and suggested that the obligations under the WTO agreements are cumulative [xiii].

4.1.2 To seek procedural improvement.

4.1.2.1 To improve the notification procedure.

What's to be worked out includes specific timing requirements in GATT Article XXIV: 7, notification responsibility under GATS V, and the requirements of completeness and validity of the documents submitted.

4.1.2.2 To reinforce the authority of the CRTA.

The aim is to help CRTA conclude its examination reports and to ensure the implementation of them.

4.1.2.3 To make full use of the dispute settlement mechanism in WTO.

To resort disputes concerning RTAs to the dispute settlement body in WTO is a way to avoid the escalation of inter-regional confrontations. By enhancing the credibility and security of multilateral trading system, it can alleviate the negative impact inter-regional conflicts may have on WTO.

4.2 To speed up the multilateral trading negotiations.

Besides preparing for the challenges regionalism has imposed on multilateralism, WTO should strive to gain renewed momentum from the advanced attempts in trade and investment liberalization at regional level. The Uruguay Round multilateral negotiations acts as an handy example on balancing the development of multilateralism and regionalism by setting even more stricter anti-subsidies disciplines for agricultural products trading than EU and NAFTA, and "multilateralizing" the rules of some RTAs like NAFTA in such new fields as intellectual property, technical and sanitary barriers.

Also, WTO needs some focused research in RTAs to pick up provident regional initiatives. In 2000, the CRTA instructed the Secretariat to prepare horizontal, thematic surveys on the treatment of various policy provisions in RTAs. And in April 2002, CRTA held a seminar on regionalism and the WTO to enhance the understanding of the impact of RTAs on the multilateral trading system. It is revealed that WTO has paid increasing attention on RTAs in an attempt to find a way out in the new development of the latter.

5. Conclusions

It should be noted that every country sees these two trends in a broader context of strategic and political considerations, resulting in an even more complicated relationship between the WTO and various RTAs in the real world. The fact that more and more countries have chosen to take part in both trends shows that regionalism is not necessarily an alternative course to multilateralism. On the contrary, as indicated in our discussion, "WTO-consistent preferential trade agreements can complement but cannot substitute for coherent multilateral rules and progressive multilateral liberalization" [xiv]. All in all, the two trends are and will keep enjoying a symbiotic relationship. We hold that both regional and multilateral mechanisms have their own limitations, thus WTO has to carry out its liberalization mission through competing with, as well as, learning from regionalism.

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End Notes

[i] See Joel P.Trachtman, "Toward Open Recognition? Standardization and Regional Integration under Article XXIV of GATT", WTO Seminar on Regionalism and the WTO, April 2002.
[ii] See Devlin French-Davis (1999) and Devlin & Estevadeordal (2001).
[iii] See Antoni Estevadeordal, "Traditional Market Access Issues in RTAs: An Unfinished Agenda in the Americas?", WTO Seminar on Regionalism and the WTO, April 2002.
[iv] On November 2003, WTO Doha Ministerial Declaration confirmed that multilateral negotiations in each of the three areas would take place after the Fifth Ministerial Conference in Cancún.
[v] For an elaboration, see Key Heydon, "Regulatory Provisions in Regional Trade Agreements: 'Singapore' Issues", WTO Seminar on Regionalism and the WTO, April 2002.
[vi] See WTO official document WT/REG/W/45.
[vii] WTO official document WT/REG/W/45, original footnote 6: "…the cost incurred for the final product to be granted originating status would not be compensated by the benefits derived from the use of the preference, either because the margin of preference would be not significant, or because the market would not be big enough, or because the product would be exported to a number of countries with differing rules of origin."
[viii] WTO official document WT/REG/W/45, original footnote 7: "The increasing importance of rules of origin may eventually lead certain producers to consider them as a factor of production …in that case, rules of origin can…result in producers increasing both inputs and processing within a preferential area at the expense of third parties that would otherwise have a comparative advantage."
[ix] See Joel P.Trachtman, supra footnote i.
[x] The factors may include "the number of members, their geographic proximity, the degree of economic, political and regulatory homogeneity among them, the length of time the agreement has been in operation and the strength of the underlying political and strategic motivations for co-operation". See Ken Heydon, "Regulatory Provisions in Regional Trade Agreements: 'Singapore' Issues", WTO Seminar on Regionalism and the WTO, April 2002.
[xi] See WTO official documents WT/REG/11, original footnote: This figure corresponds to notifications of new RTAs, as well as accessions to existing RTAs.
[xii] See WTO official documents WT/REG/45.
[xiii] For elaboration, see Joel P.Trachtman, supra footnote i.
[xiv] See Key Heydon, 2002, supra footnote v.

Achieving Synergy Effects in a Regional Economic Unity

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Abstract

This paper defines a Total Optimum as a decision that is optimal from the standpoint of the economic bloc as a total. Also, this paper defines Partial Optima as the optimal decisions in the interest of the sub-units comprising the economic block. Finally, this paper will show that a Total Optimum can only be achieved through the concession or sacrifice of the Partial Optima and vice-versa.

Introduction

The economic competition of today's world is becoming ever more severe as the competition increases among the regional blocs such as the EU of Europe, NAFTA of North America, ASEAN of Southeast Asia, etc. In the prospects of the continuation of this tendency, China, Japan and Korea feel like consolidating their economic efforts to cope with the pressures from the other economic blocs.

When consolidated efforts are needed, many leaders, political, social, or economical, have shouted a slogan, "United we stand, divided we fall." What will this slogan mean in the age of harsh economic competition among regional economic blocs? How can an economic bloc enhance its own competitiveness in comparison with others? A regional economic unity is usually comprised of many individual countries. The problem is how to unite these individual countries so that the competitiveness of the economic bloc may be enhanced most effectively. The aim of this paper is to propose a methodology to solve the problem using the concepts of Total Optima and Partial Optima.

This paper stipulates that the relationship between a Total Optimum and Partial Optima is one of conflict that often accompanies most organizational decision-making. Empirical evidence suggests that certain qualities are required of the leaders of an economic bloc if the leaders wish to implement decisions to enhance the bloc's competitiveness. Those qualities are: (1) the intellectual capacity to identify the real entity of Total Optima; (2) the persuasive capacity to attain concession from the sub-units by making the sub-units recognize this real entity; (3) the fairness to appropriately distribute the fruits obtained from implementing such Total Optima to the sub-units who have given their concession.

The method used in this paper is what they call 'problem-based learning (PBL)' in the fields of medicine, business, education, etc. The PBL method adopted for this paper starts with a hypothetical problem and through the process of solving the problem it provides us with the Total Optimum and Partial Optima of the problem. On the basis of the learning about these two types of optima we identify the relationship between the two types of optima.

Total Optima and Partial Optima

A family is the primary group of a society formed of members that share the same blood and this blood relationship acts as a very strong force that keeps people together. Thus, within a family, it can be expected that each individual will sacrifice themselves for the prosperity and future of the family. However, when it comes to a business organization, a national state, or a multinational community such as an economic bloc, it becomes increasingly difficult to expect the sacrifice of the sub-units in the interest of the community as a whole.

In today's harsh realities of global competition, the enhancement of competitiveness has become one of the most important goals for an economic bloc. In other words, it has become inevitable that some of the sub-units within the economic bloc are often required to sacrifice themselves to a certain degree in order to attain the ultimate goal of the bloc. In order to discuss this issue more analytically, let us begin our analysis with the following hypothetical case

A Hypothetical Case

Suppose that a regional economic unity, let's name it REU, is made up of three countries. Let's call these countries A, B, and C, respectively. Let's also assume that each of these countries can produce products W, X, Y, and Z. These products are produced using basically the same production facility. However, since each country has its own cost environment, the production costs per unit of each product are different from country to country as shown in Table 1. These three countries sell the products for standardized prices in the global market. The annual production capacity of each country and the aggregate worldwide demand for the products are as shown in Table 1.

TABLE 1

	Product W	Product X	Product Y	Product Z	Production Capacity
Country A	$19 per ton	$30 per ton	$50 per ton	$10 per ton	7 M tons
Country B	$70 per ton	$30 per ton	$40 per ton	$60 per ton	9 M tons
Country C	$40 per ton	$8 per ton	$70 per ton	$20 per ton	18 M tons
Capacity	5 M tons	8 M tons	7 M tons	14 M tons	

Now, our question is: Is there a way to minimize the total production cost for the three countries, A, B, and C as a whole while meeting the worldwide demand for the-products? In order to answer this question, let us first define controllable factors, i.e., the decision variables that can be manipulated by decision makers as in Table 2.

TABLE 2

	Product W	Product X	Product Y	Product Z	Production Capacity
Country A	X11	X12	X13	X14	7 M tons
Country B	X21	X22	X23	X24	9 M tons
Country C	X31	X32	X33	X34	18 M tons
Capacity	5 M tons	8 M tons	7 M tons	14 M tons	

As shown in Table 2, the decision variable X_{ij} is defined as the quantity of product j (while j=1 for W; j=2 for X; j=3 for Y; and j=4 for Z) produced in Country i (while i=1 for A; i=2 for B; and i=3 for C).

Our goal is to minimize the following sum:

$19x_{11} + 30x_{12} + 50x_{13} + \ldots + 20x_{34}$

The constraint conditions are as follows:

$x_{11} + x_{12} + x_{13} + x_{14} = 7$
$x_{21} + x_{22} + x_{23} + x_{24} = 9$
$x_{31} + x_{32} + x_{33} + x_{34} =18$
$x_{11} + x_{21} + x_{31} = 5$
$x_{12} + x_{22} + x_{32} = 8$
$x_{13} + x_{23} + x_{33} = 7$
$x_{14} + x_{24} + x_{34} =14.$

Now the task is to solve the above mathematical model and find the optimum values for the decision variables. The above mathematical model is a special form of linear programming, and therefore an application package can be used to find the optimum values as given in Table 3.

TABLE 3

	Product W	Product X	Product Y	Product Z	Production Capacity
Country A	5 M tons			2 M tons	7 M tons
Country B		2 M tons	7 M tons		9 M tons
Country C		6 M tons		12 M tons	18 M tons
Capacity	5 M tons	8 M tons	7 M tons	14 M tons	

According to Table 3, the values for the decision variables are as follows:

x_{11} = 5 M tons x_{14} = 2 M tons
x_{22} = 2 M tons x_{23} = 7 M tons
x_{32} = 6 M tons x_{34} =12 M tons,
with other variables all being zeros.

In physical meaning,
if Country A produces 5 Mega tons of W and 2 Mega tons of Z;
Country B produces 2 Mega tons of X and 7 Mega tons of Y; and
Country C produces 6 Mega tons of X and 12 Mega tons of Z;
then REU as a whole can minimize the total production cost of the four products while satisfying the worldwide demands for the products. The minimum value of the total cost is calculated as follows:

5 x 19 + 2 x 10 + 2 x 30 + 7 x 40 + 6 x 8 + 12 x 20 = $743 million.

However, the solutions obtained in Table 3 are not optimal from the standpoint of each country. For example, if one takes into consideration the position of Plant A, their production cost per unit ton is lowest (i.e., $10) for the product Z. Thus, the optimal solution from the standpoint of Country A is to produce only Z, with the following lowest possible cost:

10 x 7 = $70 million (1)

However, according to Table 3, Country A is required to produce 5 M tons of W which costs $19 per unit ton and to produce 2 M tons of Z. Doing this, the total cost for Country A becomes:

19 x 5 + 10 x 2 = $115 million.

This means that Country A has to accept the cost increase of $(115-70) =$45 million in order to make the total production cost of REU minimal.

Now, let us look at Country B. It would be best for Country B to produce 8 M tons of X for which the cost is lowest ($30 per unit ton) and 1 M ton of Y that is the next lowest cost ($40). By doing this, the possible lowest cost for Country B would be:

$$30 \times 8 + 40 \times 1 = \$280 \text{ million.} \qquad (2)$$

However, according to Table 3, Country B is required to produce only 2 M tons of X and 7 M tons of Y. This makes the total cost as follows:

$$30 \times 2 + 40 \times 7 = \$340 \text{ million.}$$

This means that Country B has to accept the cost increase of (340 – 280) = $60 million in order to make the total production cost of REU minimal.

Finally, for Country C, their best solution is to produce 8 M tons of X and 10 M tons of Z in which case the total cost will be:

$$8 \times 8 + 20 \times 10 = \$264 \text{ million.} \qquad (3)$$

However, Table 3 shows that Country C is required to produce only 6 M tons of X and 12 M tons of Z, thus making their total cost as follows:

$$8 \times 6 + 20 \times 12 = \$288 \text{ million.}$$

This means that Country C has to accept the cost increase of (288 – 264) = $24 million in order to make the total production cost of REU minimal.

Now, applying the definitions of Total Optima and Partial Optima as provided in the previous section, the solution as shown in Table 3 is the Total Optimum, while the solutions described in equations (1), (2), and (3) are the Partial Optima.

The Conflict between Total Optimum and Partial Optima

Ideally speaking, the sum of all Partial Optima should become equal to the Total Optima. However, such an instance is generally difficult to take place except by a sheer coincidence. In our case, the Partial Optima from the standpoint of the three plants do not match the Total Optima.

In general, there exist conflicts between the Total Optimum and Partial Optima. In other words, the Total Optimum may only be achieved through the concession or sacrifice of Partial Optima. The conflict between the two exists in all communities and organizations that comprise their sub-units.

How to Resolve the Conflict

For an economic community to increase its competitiveness, the Total Optimum should be sought at the sacrifice or concession of Partial Optima. However, we have to also admit that the whole cannot thrive on the destruction of its sub-units. Therefore, if the situation arises in which the very existence of some of the sub-units is threatened, then the sub-unit has to be allowed to realize its Partial Optima so that it may stay alive. The following example is such a case.

The 1984 L.A. Olympic Games Organization Committee

The 1984 Los Angeles Olympic Games Organization Committee headed by Peter Ueberroth had to prepare for the games without any financial assistance from the federal government. The federal government was not in a position to assist the committee since it was suffering from deficits. One of the ways to create the necessary funds for the Games was to ask for donations from supplying companies, and in return, give them monopoly in the supply of certain goods or services. Among the things that would be needed during the Games were films, but the L.A. Olympic Games Organization Committee had to go through a very difficult decision making process in giving official sponsorship for films. The company with the longest tradition and history was the American company Kodak and everyone expected that Kodak would become the official sponsor. However, being the strongest candidate, Kodak maintained a standoffish attitude and suggested that they would be willing to donate one million dollars. On the other hand, the Olympic Games Organization Committee had already come to the conclusion that they need to secure at least four million dollars from a film company. It was a dilemma.

At that time, Japanese Dentsu Inc. suggested a donation of seven million dollars for the sponsorship of Fuji films and added that they would develop all films for the Committee free of charge. Fuji Films was a Japanese company and at that time, the U.S. was suffering from trade deficits with Japan. Considering national pride and trade deficits, it was natural that the L.A. Organization Committee would give sponsorship to Kodak. This could be seen as a solution to achieve the Total Optimum for the U.S. Nevertheless, it was not easy for the Committee to reject its Partial Optima, a seven million-dollar donation. In the end, the Committee opted for the Partial Optima, and as a result, was able to stage the Olympic Games successfully. There was no blaming the Committee.

The Leadership for the Achievement of Total Optima

In today's world of global competition, the leaders of economic blocs should ask for the sacrifice or concession of its sub-units to give up Partial Optima so as to maintain the competitiveness of their blocs. The problem is how to achieve this. What are the viable methods? Let us look at the following case:

General Electric versus K Corporation

In the late 1980s, an anonymous company, let us call it K Corporation, in a developing country began to expand into the world market with cutting and grinding tools made with synthetic diamond. Technical knowledge to make the synthesized diamond was first developed by General Electric (GE). Thus when K Corporation appeared and began to expand their market in the area, GE began to take notice. GE believed that K Corporation had stolen their know-how in producing synthetic diamond and thus asked an American intelligence agency to begin surveillance on a Mr. K's visits to the U.S. Mr. K was an engineer who had retired from GE. Eventually, Mr. K. was arrested at an airport in the U.S. with the documents he was carrying confiscated, and was prosecuted by the American government. GE demanded that K Corporation immediately stop all sales of relevant products and that K Corporation should pay retrospective compensation for all the products that have been sold. K Corporation did not have any knowledge of the court procedures in the U.S. and it seemed to be a matter of time that they would lose the lawsuit.

At that time, GE was selling products such as jet engines, power plant facilities, medical equipment, etc. to the country that was the home country of K Corporation. Thus, Chairman J. Welch, then CEO of GE, visited the country, and asked about the public sentiments of the people on the case of GE versus K Corporation. Chairman Welch learned that if GE, a giant enterprise, were too harsh against K Corporation, a small company, people in the country would have a very bad impression of GE and that this might even lead to unfortunate social movements such as a boycott against GE products.

Chairman Welch, who had a good sense of global management, called his people of the department of synthetic diamond and persuaded them that they be lenient on the case against K Corporation. He managed to obtain their concession by making them see that it would be a better decision in light of the Total Optimum for GE. Eventually, GE began negotiations with K Corporation, and the original harsh demand of immediate end of sales and retrospective compensation was withdrawn. Rather, they reached a mutually agreeable solution at the level of K Corporation paying an appropriate royalty for future production.

This case of GE versus K Corporation shows how the Partial Optima from the standpoint of the synthetic diamond unit of GE was adjusted for the Total Optimum of GE as a whole.

The Political Philosophy of President Park Chung Hee

In the 1960s, Korea was one of the poorest countries that had just gone through the Korean War. The foremost priority for President Park, who had assumed his power after a military coup-de-tat, was to bring economic development to Korea through industrialization. Thus there was a succession of 5-year economic development plans and within 30 years, Korea was able to get into the level of a developing nation. However, this success was not without negative consequences. It resulted in widening the gap between the rich and the poor which, in turn, led to social side-effects.

President Park thought that the only way to achieve national unity was to reduce the feeling of isolation of the poor by suppressing the consumption of the rich. One way of actually implementing this thought was realized in the policy to postpone the broadcast of color television programs. Around the later part of the 1970s, Korea had already become one of the leading countries to export colour televisions. However, President Park did not allow broadcasting color television programs within Korea. Thus, the Korean people had to watch black and white television until after the death of President Park in 1979. This case is an example that shows how the Partial Optima of a sub-unit (the rich people) in the form of fulfilling the desire for color television was sacrificed for the achievement of the Total Optimum in the form of national unity through narrowing the gap between the rich and the poor.

This political philosophy produced a ripple effect down to the enterprise level. In companies that had factories without an air-conditioning system, the management offices also went without air-conditioning. This was done so that unity would be maintained between the laborers and the management under the catch phrase "Let us, the labor and management, work hard and overcome hardship together." However, it is perhaps the natural tendency of humans to strive for Partial Optima. The social atmosphere of consumption repression began to fall apart and the social gap between the rich and the poor widened. Politicians began to lose the trust of the poor people in the early 1980s. Thus began the serious conflict between labor and management in the mid 1980s.

Conclusion

Business organizations need to produce synergy effects by consolidating their sub-units and thereby increase competitiveness in order to survive in the global market. The word synergy comes from the ancient Greek word "synergos" which means "working together" (Goold and Campbell, 1998, p. 133). However, the synergy effect cannot be gained by simply working together. This paper has shown a way to produce a synergy effect by achieving what this paper called the Total Optimum. The Total Optimum, the best state of a system from the standpoint of the total, can only be achieved through the sacrifice and concession of the Partial Optima, the best states of the sub-units from their own standpoints.

Some scholars maintain that they will to sacrifice Partial Optima on the part of the sub-units in favour of the Total Optimum is in functional relationship with the culture. Geert Hofstede describes the society that has a relatively high will to sacrifice Partial Optima for Total Optima as "collectivism" and the opposite case as "individualism" (1991, pp. 49-67). In his 1991 book, *Cultures and Organizations*, Hofstede studied the strength of the tendency for collectivism in 23 areas around the world and came up with an index that showed this strength. This data showed that individualism was prevalent in the western countries while collectivism was strongest in Confucian cultures such as China, Japan, and Korea.

What kind of culture one may be in, however, it is never easy to pull out concessions of the Partial Optima in favour of Total Optimum. For each sub-unit, priority would be placed on matters that are concerned with its interest. Thus, if the competitiveness of the whole is to rise, there is a need for a strong and persuasive leadership to achieve the Total Optima by getting the concession of Partial Optima (Hunt, 1991).

Today's competition in the global market is becoming ever more severe as economic blocs are created. However, even economic blocs would have to meet the following conditions in order to achieve their synergy effects: (1) clearly identify the real entity of the Total Optima of the bloc; (2) persuade the individual sub-unit to make concessions for the realization of the Total Optimum; and (3) devise and maintain a trustworthy system that will distribute the benefits of the Total Optimum fairly to all participating sub-units that sacrifice their Partial Optima.

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Conducting Business in Europe, Third Millennium

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Abstract

This paper intends to discuss the response from the nationwide type of company to the European-wide market-model integrating the 15 member European Union, the 12 nations joining in 2004-2007, and the moving forward agreements with next candidates and neighboring Mediterranean nations. They are all integrating a new kind of multinational community sharing, totally or selectively, the free flow of trade, capital and people, and the euro currency. Cultures, languages, and economic background may differ, but the new model exhibits half a century of sustained advancement. It sits on an underlying commitment to mutual understanding, aiming to peace, stability and development. This cuts business transaction costs, hence encouraging interaction, investment and trading, and propelling long term prosperity. Consequently, the frontier is moving ever ahead, widening the opportunities for every step of the business value chain, but exposing to lifting competitive forces. Which is the answer from the nationwide type of enterprise?

Introduction

There is a significant group of mid size companies with limited geographical scope, i.e. the Iberian Peninsula (Spain and Portugal), and only sporadic activity in international trade. Actually, they find themselves before a major challenge: to assess their strategic position in relation to the spreading European Union (EU), taking into consideration the member nations as well as candidates and associates. Every EU step forward, like the transition of candidates into membership, or the upgrading of agreements with neighbor countries, is often perceived as a mix of open opportunities alongside threatening disturbances.

This analysis originated in Fall 2002, after a half a day seminar organized by the European Commission. It took place in its office in Barcelona, Spain. The subject was the enlargement of the EU from 15 to 25 members, to be effective by mid 2004 (see Section 1 below). The event was addressed to the corporate management of the Barcelona area that is a major business region in Spain. There were representatives of the European Commission, the local Government, and various Business Associations, as well as invited speakers. It was presented as an illustrative, updating session on a significant European evolution, but the number of attendants was extremely limited, in spite of ample publicity. The tenor of the presentations was optimist, but the audience looked visibly hesitant. At coffee break, the representative of a Business Association made a significant comment when expressing a growing concern in his milieu, related to the aggressiveness of new competitors from joining members, like Poland of the Czech Republic, based on relatively low salary levels and therefore providing a cost saving alternative to operations actually run in Spain. At the end, feelings were mixed. The reason for the lower cost alarm was certainly understandable, but, was it equitable? If listening to all speakers and trying to balance their reports, there appeared to exist two sorts of trends. First, an expanding marketplace, especially on the part of new members demanding unavailable technology and products. And second, newly emerging options for all types of joint alliances, starting with cost cutting subcontracting, that is true, but extending to all steps of the value chain, like valuable distribution channels opening commercial activities in new markets.

The following three sections intend to display the background, the present and the foreseeable future of the EU, to draw the extent of its effective frontiers, to discuss the corporate strategic response and, finally, to reason the kind of organization and team skills required for a successful action plan.

Section I asserts the forces leading to the initial establishment and to the persevering advancement of the EU. First was the European Economic Community. Next came the gradual enlargement to the present 15 member EU. The following step is the incorporation of 12 nations by 2004. At the same time, there are the commercial agreements with lining candidates and the Southeast Mediterranean countries. This evolution opens new areas of business opportunities, broadening the existing fields of action, and calling for attention to a quickly changing environment.

Section II states the vision, the strategic plans and the actual performance of a number of companies that hold a determined European wide perspective and search for adapting to, and take advantage of, the emerging, ever expanding, new experience.

Section III addresses the inside of the company and proposes a reasoning exercise aimed to designing the course of action that better suits the changing scenery. This comprises the culture and the structure of the organization, and the upgrading of all functions.

Section I: The European Union, a stepping up progress

The roots of the EU seem to lie in ancient times.

When looking at the social and economic progress of the Greek city, the *polis*, Aristotle (IV BC) understood that nature compels people to live in community, searching for a greater well-being than living or working in isolation. The philosopher described the *polis* as a perfect community of villages originating out of the necessities of life and existing because of granting a better living. He wrote: "The city is a reality of nature, driven by the social character of man." This argument may apply to a larger area than the city: the community of nations intended to assemble their citizens in a single political project fostering the cooperation in knowledge development, the discussion of joint propositions, and the economical welfare, within the overall objective of constructing an environment of peace and prosperity.

The Mediterranean Sea was the site of the first economic community in history. Its target was the expansion of trade. Around the 13th century BC, Phoenicia began its incursion into the Mediterranean. The Phoenicians were artisans, sailors and traders who had developed a flourishing economy in the Eastern Mediterranean and felt anxious to expand to the western coasts. Larnaca, Cyprus, *the island of copper*, was the first colony (10th century BC). They later reached Crete and Sicily, as well as Carthage (9th century) that became the predominant center for western trade. Gades (Cadiz), south of the Iberian Peninsula, was the main Phoenician port and trading spot for Iberian minerals. Greece took over, increasing the number of colonies and introducing the coined money as a means of exchange. Corinth was their center of operations. The port of Piraeus had depots used by merchants from eastern and western sides. The period between 400 and 350 BC was brilliant: mercantile exchanges were fluid, Athens acted as administrative center, and an increasing number of competitors struggled to gain market share and accumulate capital resources. Roma consolidated such a development by adding technology, organization and even a common currency, until collapsing as from 200 AD.

The birth and development of a new model

That historical event is duplicating. The first half of the twentieth century was a turbulent period where two world wars, originating in Europe, devastated the European Continent and inflicted major social and economical damage. Such a chaotic event encouraged a group of nations to search for a new framework restoring peace and stability, for these are fundamental conditions to promote the interaction between nations, eventually leading to the progress of science, technology and trade, and finally granting social and economic advancement. The first step took place in 1950. This was the “Schuman Declaration”, inviting the European nations to join the French-German initiative on a common market for coal and steel. Robert Schuman (French Minister for Foreign Affairs) based his statement on the enlightening design of Jean Monnet, the *architect* of the modern Europe. The CECA (standing for European Community for Coal and Steel), was signed in Paris (1951) by France, Germany, Italy, Belgium, Holland and Luxemburg.

This was the first step. The genuine departure took place in 1957 when the same six countries signed the Treaty of Rome, setting the foundations of the European Economic Community (EEC), and establishing a free trade area for 200 million inhabitants. This was the embryo of the actual 15-member EU. Nine nations adhered in between 1973 and 1995: United Kingdom, Ireland and Denmark (1973); Greece (1981); Spain and Portugal (1986); and Austria, Sweden and Finland (1995). All but three (United Kingdom, Sweden and Denmark) share the euro currency since 2002. R. Schuman and J. Monnet would have hardly dreamed of EU with 379 million citizens (2002) taking the free flow of trade, capital and people just for granted, and sharing an economical and monetary union. This has been an impressive development, as underlined[1]: “Compare Europe now with Europe 50 years ago, and you do not have to be a genius (...) to conclude that the EU has been one of the great political success stories of the post-war world”.

In the same report, *The Economist* added that: “is merely the story so far. Europe is still very much a work in progress”. Right, the progress is on the way. A new expansion will be completed by 2004, following the agreements approved in Athens (April 2003). The 10 new members are: Estonia, Latvia, Lithuania, the Czech Republic, Slovakia, Poland, Hungary, Slovenia, Cyprus and Malta. This will build a UE of 25 members and 454 million citizens (2002). Next will be Romania and Bulgaria by 2007, adding 31 million and achieving a 27-EU with a population of 485 million (2002), equal to 8 % of total worldwide.

The 15-EU generates around 20 % of world GDP. First results for 2002 [2]reported a GDP of 9.161 billion €, 1 % above 2001. Over the last four years, the 15-EU economy has increased by 9.2 %. The main contributors are three previous laggards –Ireland, Spain and Greece– that have grown by 37 %, 14 % and 17 % in the same period. The GDP per capita has risen to average 23.970 €. The four main nations –Germany, France, Italy and United Kingdom– run slightly above. Spain (17.000), Portugal (12.500) and Greece (12.900) find themselves in the lower positions, although gradually catching-up. In fact, the gaps are smaller when adjusting for market price differences, which are in terms of *Purchasing Parity Standard (PPS.* The adjusted GDP per capita are 19.900, 17.300 and 16.500 €, respectively.

The 12 candidates joining in 2004 and 2007 (CCS) achieved a GDP of 502 billion € in 2002, equal to 1.005 in *PPS* terms [3] They add 28 % to the EU population but only 5,5 % GDP (11 % in *PPS*). However, the group has grown by an impressive 43 % over the last four years, comparing to 9.2 % (see above) in the case of the 15-EU. In fact, the firm progression started in 1994, after a painful political transition. The *catching-up* race has clearly started before membership, in spite of many adjustments still in process regarding communication and technological infrastructures, as well as production equipment and organization. The leaders are the Czech Republic, Slovenia, Hungary and the Slovak Republic. Even after that quick step up, the average per capita GDP raised to 9.500 € (2002, *PPS* adjusted), comparing to 23.970 € for the 15-EU (see above). The gap is still remarkable, and then the *catching-up* will probably go on.

Turkey is the next candidate. The integration process may take as long as 10 years, but there is an increasing association to the EU by means of commercial agreements and direct investments. It has a population of 68 million, thereof 30 % below 14, a sharp contrast with only 18 % in the 27-EU. Turkey reported a GDP of 192 billion € (383 in *PPS* terms*)* in 2002[4]. It grew by 18 %, after a discouraging, negative, 2001. Last four years have aggregated 8 % growth. The GDP per capita (*PPS* adjusted) increased in 2002 to 5.500 €, comparing to average 9.500 for the 12 new members and to above 23.970 for the 15-EU. Given the existing interacting trend, and unless there are disturbing political or social uncertainties, the *catching-up* process should continue as in the case of the other candidates.

Following the above facts, the *operational* EU does stretch to 28 members, with 553 million citizens (9 % of worldwide) and 9.855 billion € nominal GDP (around 27 % of worldwide). Everyone’s willingness makes it a solid enterprise. There are open issues to deal with, as the agricultural policy, but a great majority feel like belonging to the *right club*, as proved by the affirmative answers to membership referendums than have taken place in 2003. When asking Jacek Saryusz-Wolski, the head of Poland’s office for EU integration, why his country wants to join the European club, he laughs: “I haven’t thought about that for ten years”. He will cite economic, diplomatic and strategic reasons, but the ultimate argument is “civilisational”, as one of his colleagues puts it: “Imagine there is a river running through Europe, dividing east from west. We have to make sure we are on the right side of the river”[5].

There are more in the party. Next is the Euro-Mediterranean partnership, launched after the Barcelona Convention, in 1995[6]. It comprised 12 Mediterranean Partner Countries (MPC). Actually, Cyprus and Malta are joining the EU in 2004 and Turkey is an official candidate (see above). This cuts the number of MPC to 9. They are: Morocco, Algeria, Tunisia, Egypt, Jordan, Lebanon, Israel, the Palestine Authority and Syria. Their population is 166 million, with 36 % below age 14. Excluding Israel, total GPD, at current prices, is 327 billion € (2000). The GPD per capita, *PPS* adjusted, is below 5.000 with the exception of Algeria and Tunisia, than run slightly above. Israel has a per capita DGP of 20.000 €, near the EU-15 average. There are two interesting facts insofar the Magreb is concerned. First is the economic growth during the five years after the Barcelona Convention (1995-2000), where Morocco, Tunisia, Algeria and Egypt have expanded by 20 %, 33 %, 17 % and 31 %, comparing to 5 %, 21 %, 1 % and 18 % for the previous 5 years to 1995. Second, the investment in equipment and infrastructure was the biggest contributor to GDP in year 2000, laying the grounds for continued development.

A continent of opportunities

This state of affairs points to five issues calling for business management attention. First is the *catching-up* effect that drives the relatively higher advancement of modest nations. Second is the rising flow of direct investments, that responds to the opportunities perceived by a number of companies, even mid size ones. Third is the fast growing intra-community trading flow, that is related to the emergence of cost and technological clusters, and builds entry barriers to non-community parties. Forth is the regional compensation gap. Finally, there are the population and immigration trends.

The first issue is the *catching-up* effect. Following a study conducted by the Harvard Institute for International Development[7], global patterns of growth during the period 1965-1990 were shown to depend on four factors: initial conditions, physical geographic, government policy, and demographic change. Initial conditions matter in the sense that, other things being equal, poorer countries tend to grow faster than richer ones. This is the *catching-up* effect. Economic policies proved crucial to support its development, for open economies grew 1,2 percentage points per year faster than closed. The basic condition is good government, granting stability and contract compliance. The world GDP grew by annual average 3,4 % during 1981-1990, but the developing countries reported 4,2 % in front of 3,1 % for the leaders. China and the Pacific *tigers* escalated to top places by achieving 6,9 % annual growth. This applies as well to modest EU new members. During the period 1986-1991, just after incorporation, Spain and Portugal achieved a GDP growth of 23 % and 29 %, comparing to average 17 % for the whole EU. Spain and Greece still held the *tempo* during 1999-2002, with 14 % and 17 %, that is well above 9 % for the EU. The CCS have undertaken their particular *catching-up* process, as proved by their superior economical growth (see above) during 1998-2002. Various analyses anticipate a similar future, for the CCS is far away from balance in relation to their partners. The "potential future growth rate" of the 12 candidates is estimated at around 5 %[8].

The second issue is the foreign direct investment (FDI) into CCS. Their growing trend requires a sustained inflow of FDI, for they miss the accumulated savings that would grant the required financial resources. They need to upgrade their knowledge and technology, too. Indeed, FDI into the 13 CCS (including Turkey) raised from 10 billion € in 1995 to 25 billion in 2000. There is a correlation between the FDI and the degree of economic openness (calculated as the relation between foreign trade and GDP), which progressed from 69 % to 85 % in the same period. The FDI have increasingly financed the deficit of the current accounts of the CCs, from 54 % in 1994 to 80 % in 1998 and 71 % in 2000[9]. It is clear that stability and fair government open borders and reduce transaction costs, so encouraging free trade that subsequently calls for increased FDI on the part of multinational companies to produce for domestic and export markets, eventually engaging the economy into a lively circle. All are interrelated.

The FDI flowing into the 12 MPC that signed the Barcelona Convention in 1995 (see above) is still modest and varies in relation to prevailing opportunities, i.e. privatization plans. But it heads the MPC to GDP growth rates high enough to reduce unemployment and improve the social situation. FDI run below annual 0,8 billion € until 1995. Then, it steadily increased to 2,2 billion in 1998, to drop to 0,7 in 1999 and finally set record amounts in 2000 and 2001, with 3,7 and 2,3 billion. This analysis includes Turkey, that went up from 0,3 to 1,3 billion in 2001. The Magreb countries have kept at annual 0,5 billion. FDI to Egypt is unimpressive with the exception of 2000, when reached 1,2 billion [10]. The lack of stability, coupled with uncertainty, highly attach FDI to prevailing opportunities. However, the flow is permanent and generates a progressive impact on the trade flow (see above).

The third issue is the trading between partners. The European environment drops political and financial barriers, builds trust, opens communication and, consequently, reduces transaction costs. This encourages intra-trading. The 15-EU share of world trade, in between 1980 and 1999, increased from 37 % to 39 % in exports, and declined from 41 % to 38 % in imports. The extra-EU share dropped in both, from 15 % to 14 % in exports and from 19 % to 14 % in imports. Therefore, 64 % of *international* trade was in fact *intra-trade*. At the same time, the EU achieved a balanced trade flow (export less import) with nations across community borders, replacing *extra-imports* with internal transactions (WTO, 2000). Checking an specific example, the EU share of Spanish exports increased from 54% of total worldwide in 1986, when joining, to 71% in 2000, while the share of imports from the EU developed even more sharply, rising from 39% to 63% in the same period, maintaining this ceiling in 2001 and 2002 [11].

At the same time, the CCS share of the 15-EU extra community-trade just doubled from 1992 to 1999, from 5 % to 10 % in imports and from 6 % to 12 % in exports. The shifting to the new partners, in the case of the 15-EU imports, responds to favorable manufacturing and transaction costs, and to proximity. Exports often relate to providing technology and equipment. Multinationals have played a visible role[12]. See related cases in section 3 below.

The fourth issue is labor cost, where the divergence is sizeable. The average cost per hour in the 15-EU (annual salary plus benefits and social contributions, divided by annual hours) was 22.19 € in 2000. The top is at Financial Intermediation (34,28) and Energy (30,02). The lowest is at Construction (19.09) and Hotels-Restaurants (14,63). Average of CCS is 3,47 €, one sixth of above 15-EU, with a similar scale by sectors. There are significant disparities between countries. In the case of the 15-EU, Sweden (28.56) is at the top, followed by Germany, while Spain (14,22), Greece and Portugal (8,13) are at the bottom. Regarding the CCS, Poland leads (4.48), whereas Rumania and Bulgaria (1,45) are at the low end. In manufacturing, averages are 22.75 and 3.95 €, with similar country rankings. However, the study underlines that "lower levels of labor costs per employee are associated with lower levels of labor productivity", supporting that theory with the correlation between salary level and total value added in the 15-EU, which signals that the combination of the two significantly reduces the labor costs advantages[13]. In summary, the right strategy must balance labor cost with training and technological applications.

The fifth issue is population, in particular its age distribution and the immigration trend. As shown above, the 27-EU (15 actual members plus 12 CCs) will have 485 million citizens, with only 18 % below age 14. Turkey, the next candidate, has 68, with 30 % below 14. The 9 MPC sum up 166, thereof 36 % below 14. Worldwide, the segment below 14 accounts for average 30 %. As a result, the 27-EU gets older, for the segment above 65 is close to 13 % in front of 7 % worldwide. This development may have various implications, i.e. the contraction of the labor force and the consequent economical regression, the distressing of social security and public retirement programs, and visible shifts in market demand. But it also impels to re-balancing, either increasing fertility rates, or immigration, or turning to Turkey and to MPC for increased supplying of labor intensive products and services.

Immigration is a fact. The EU attracts rather young, determined citizens from deprived areas, mainly Africa and South America. At the same time, Eastern European increasingly presses on moving to the West. The size of net immigration is hardly measured, but most probably exceeds one million per year (2000-2002). During 1995-2002, net immigration has added at least annual 0.2 % to EU population, equal to in between 5 and 6 million citizens for the complete period. Natural increase just counts for 0.05 %, as a result of a low total fertility rate (average number of children that would be born alive to a woman during her lifetime if the current rate were to continue), that maintains at around 1.47[14].

The defining traits

All in all, the European development may be highlighted by the following traits [15], that intend to clarify the end of XX century's global trends:

First, "the Cold War system was characterized by one over-arching feature: *division*", for the world was a divided-up place. The symbol was "the *Wall*". The new system has another "overarching feature: *integration*", for the world is increasingly interwoven. The corresponding symbol is "the *Web*".

Second, "the defining document of the Cold War system was "The *Treaty*". Again, there is a different document for the globalization era: "The *Deal*".

Third, the Cold War was known as "a world of *Friends and Enemies*". Now, "the globalization world, by contrast, tends to turn all friends and enemies into *Competitors*".

Friedman also writes that such changes require a clear democratization in four areas: technology, finance, information and decision making. Then, good governance should grant the free flow of technology, finance and information, and "the best CEO will be that who understands that their job is to chart the broad corporate strategies, to establish the broad corporate culture, to get the balls rolling on the right paths and then let those closest to the customer and to the rapidly changing marketplace manage those balls on their own". The management's response will be further discussed in the next two sections.

Then, *Web, Deal, Competition and Democracy* seem to be the traits that support the progression of the EU model.

Further expanding the Web

A final addendum to this section: the EU is signing agreements with members of other communities. The first was the Agreement on Free Trade between Mexico (member of the North American Free Trade Agreement: NAFTA) and the EU, signed in Lisbon in March 2000. It anticipated the gradual elimination of tariffs, in such a way that all Mexican products shall have free access to the EU by 2003, whereas a top 5% duty will remain in place for 40% of European goods. By 2007, trade shall be entirely free. The second was the Agreement with Chile (member of the *Mercado Común del Cono Sur:* Mercosur) and associated to NAFTA as from 2002. Until recently, such accords used to take place between nations. Actually, a Community of Nations is involved. The *web* is expanding.

Section II: The Corporate perspective

Actually, the first bunch of corporations fully determined to expand its operations in the European Economic Community (EEC), born with the Treaty of Rome (1957), was not European, but American. As a matter of fact, the Department of Commerce, Washington D.C., found it astonishing that American business investments, 1966 opposite to 1965, had increased by 40 % in the EEC, comparing to just 17 % in the domestic Market and 21 % in the rest of the world. The EEC "becomes the new frontier of the American Industry"[16]. In 1963, the American companies were already leading the new and starring electronic field, with 15 % market share of consumer appliances like radio and TV sets; 50 % to 80 % of components for the newly born computer industry, and 90 % of integrated circuits. Their knowledge superiority was widely recognized. By the end of the sixties, the American firms had conquered top positions in the European Chemical, Electronic and Automobile industries –in sales and profits. According to Servan-Schreiber, the Americans brought to Europe a new management style, entrepreneurial and pragmatic. They made mistakes but "the time needed to correct them is negligible comparing to local competitors". They demonstrated "a quick adaptation capacity allowing them to fully understand the local environment". In fact, "the flexibility, rather than the superior financial resources, is their basic arm". The list of *invaders* was headed by such names as Du Pont de Nemours, Union Carbide, General Electric, IBM, General Motors, Ford, and many others.

Next cases illustrate the corporate answers to the European model. The first management drive, when shifting from nationwide to continent-wide, may be associated to a variety of reasons, i.e. the short term need for corrective action in relation to revenue, operational cost, or both; the opportunity to benefit from either technological or commercial alliances; the decision to expand into unknown markets; and the decided enhanced, long term, planning vision.

The answers of Braun, Poliglas, Saint George and Mango

In the late seventies, Braun Spain was a modest manufacturer of small electrical appliances for kitchen and home use. Even being a subsidiary of Braun AG, Germany, since 1963, the Spanish management was largely self-ruling insofar the local industrial and commercial operations were concerned. 95 % of sales were achieved in Spain, that experienced a terrific expansion during the first half of the seventies. The company was more than pleased with domestic results, paying little attention to export opportunities that were sporadic and accounted for just 5 % of turnover. This state of affairs changed drastically after 1977 as a result of a double crisis that caused a major impact on the domestic market: the oil price jump and the transition from dictatorship to democracy. The reaction consisted of searching for opportunities within the EEC. The natural partners were the Braun commercial subsidiaries distributing the products made in Germany, but they were little aware of the Spanish range. Then, the initial step was persuading the new commercial partners by showing them the Spanish success story, and demonstrating the competitive advantages of the Spanish appliances. Next was gradually adapting the local products to the specific European market demands. Another key condition was an accurate logistics service. At the same time, the Spanish team applied hard to upgrading their skills in a number of areas, i.e. foreign languages, understanding international standards, meeting specific market demands, and upgrading practices guaranteeing the targeted quality and cost levels. Italy, France and the Netherlands were the first positive experiences. In parallel, the preferential agreement signed in 1970 opened the door for Spain to full membership of the EEC that was effective in 1986. This eliminated barriers and eased the expansion to all West Europe. By the end of the eighties, turnover had more than doubled, with *exports* to Europe already exceeding the domestic's sales volume. Then, a Corporate Business Management team was created to assure the European coordination in product planning and distribution, regardless of manufacturing source.

Poliglas is a mid size Spanish company founded in 1952. They have developed a solid knowledge in thermo and acoustic isolating materials used in the building industry. By the mid nineties, their commercial and industrial operations covered most of Western Europe. Factories were based in Spain, Italy and Germany. This was the time for the Hungarian operation that was started in 1997. The company was determined to widening its technical and commercial horizons. The Hungarian base material was *rock wool,* while Poliglas had specialized in *glass wool*. The combination of the two technologies would most probably expand the number of product applications. On the other side, Hungary might provide two benefits: the expansion in growing Eastern Europe markets and the cooperation with the existing German Plant in knowledge development, with the subsequent impact on EU markets. The acquisition of the Hungarian Plant demanded a strong management commitment to a range of issues. First, the understanding of the local cultural (starting with language), as well as the political and the working environments. Second, the correction of limiting factors like the low productivity and the unstable quality level resulting from a long period of poor management. Third, the elimination of certain costs connected to sourcing uncertainties and unfair bureaucratic practices. Another area of concern was the financial area, for inflation was as high as 12 % and interest rates were escalating. Finally, the international trade was still far from free. On the positive side, the nominal salaries were low in relation to EU standards, although the cost of living and the low productivity were probably to limit this advantage. Looking at the future, Hungary had been accepted as candidate to member of the EU and was opening a restructuring process. The action plan consisted of a precisely organized and controlled transition period, managed by a mixed Spanish and Hungarian team. It succeeded to correct and upgrade every function of the Plant, along with improving the planning and logistics of cross country operations. At the same time, the Eastern demand actually increased, partially compensating for lost jobs. Finally, a productive interaction with the German Plant was fully running in just one year. To maintain a fair social atmosphere, redundant employees were even offered financial and technical assistance to start their independent business.

Saint George's Mills Commercial (SGMC) was incorporated in Greece (1996) by two shareholders: Sant George's Mills (SGM) and Commercial Capital (CC). SGM, founded in 1926, was the leading milling company (consumer packaged flour) in the Greek market. CC, founded in 1993, was the asset management branch of the Commercial Bank of Greece. SGM was prospecting the Eastern and Central European (ECE) market to invest in mills and bakeries. CC considered ECE as a unified region of which Greece was a part, for historical ties. Additionally, its major transition to joining the UE qualified Greece to understand the challenges that ECE was experiencing in its own turnaround. Then, the two shared the same strategic direction: a long term alliance covering the full region, aiming to acquire companies that could be restructured to increase profitability. They pointed at the markets unfocused by most Western investors, in particular Albania, Bulgaria and Romania. The first identified target was Titan, the largest flour mill and bakery in Bucharest, Romania. Over the last three years, Titan management had succeeded to improve the quality of its products and raise sales significantly, crafting an excellent brand name. In 1997, the Romanian government opened a privatization process, allowing SGMC to proceed with a bid. Then, the deal was in progress. SGM knowledge could be transferred to the new acquisition, with good potential for launching new products into the Romanian market. The Romanian state control on foreign trade still limited the exports from Greece, but the increasing interaction with Central Europe was bringing a gradual change. On the other side, there were rumors on an eventually joining the EU. Then, this was the time to start the partnership[17].

Mango is a Spanish fashion clothing company. Its retail strategy is based on 600 own or franchised outlets (2002) located in 70 East and West Europe countries, Latin America, Middle East, Asia Pacific and North Africa. Sales have tripled during the period 1993-2000. Mango's management has identified two basic strategies to support its successful advancement. First is the permanent upgrading of the company's organization. This includes the quick flow of information, the continued training, the coordination of worldwide activities, and the effective interaction between all functional teams. This applies to a worldwide organization integrating 6.000 own employees plus 31.000 in franchised stores and subcontracted manufacturing and logistics operations. Mango's management fully asserts that depending on such a multitude demands an overwhelmingly open, building oriented mind, devoted to innovation and to learning from diversity. The second strategy addresses the support to two core competences: product design and logistics. Product design includes global fashion trends, new textile materials, and design technology. The right combination is key to a continued flow of innovative products, at reasonable prices. The other flank is the clear command of logistics technology, for flexible planning, and quick distribution from plant to retail outlets, is mandatory conditions. According to Mango, manufacturing (80 % of full cost) is a *commodity* available to all competitors. Then, the keys are mastering core competencies and building a strong technical and commercial partnership, for this leads to excellent design, fine tuned manufacturing operations, and on time delivering for commercial achievement.

Going East and South

Multinationals go east, again, but not only the American ones. The Slovak Republic's GDP increased 16 % during 1998-2002, comparing to average 12 % for both the 13 CCS and the 15-EU. This has raised the GDP per capita up to 11.350 € in 2002 (*PPS* adjusted), still half the 15-EU but well above the average 7.950 € for the 13 CCS[18]. The reason for this positive development lays in the business oriented environment created by the Slovak government – i.e. political stability, free trading and lower taxes– along with well trained employees making salaries well below their Western colleagues. Examples of companies moving operations to Slovakia are Sony, Volkswagen, Siemens, Motorolla, Rhône Poulenc, Unilever, Coca-Cola and Nestlé. Poland, the Czech Republic and Hungary follow the same direction. Even Romania and Bulgaria (to join in 2007) already share the course, with companies like Procter and Gamble, Pepsi Cola, Reynolds, Daewoo, Siemens and many more already installing there. This generated a FDI to CCS of 20 billion dollars in 2000 [19]

Following the agreements of the Barcelona Convention (1995), the partnership between Spain and Morocco has strongly developed. During 1995-2000, annual Moroccan exports to Spain have increased from 432 to 965 million €, and imports have equally grown from 590 to 1.368 million €. About 800 Spanish companies have opened operations in Morocco. They have permanently increased their FDI from the mid nineties. Some are major industries, like Gas Natural, Endesa (electricity), Repsol (oil), Sol Meliá (hotels), Cortefiel (textile) and Roca (bathroom equipment). But many are small. Most activities are related to textile and agriculture connected industries. Moroccan tomatoes are a subject of debate, for Spain is a major producer, too. On the other side, joint ventures in fishing are on the right track.

Confecciones Catalanas, near Tanger, employs 500, working 50 hours per week, with salaries slightly above 1 € per hour. The company makes 25.000 garments weekly that are shipped directly to European outlets. Productivity is consistently improving, according to the company's management, because of caring for permanent training. But other Spanish companies in the textile industry have elected to turn to around 500 subcontractors in the Tanger area, employing 30.000 with salaries below official minimum (0.90 € per hour) and no social security coverage[20]. Corporate responsibility is under scrutiny. A complementary example of determination is STE, a Spanish engineering and manufacturing company in the packaging industry. According to its management, "the market is changing in Tunisia and Algeria because of privatizations, and this is a unique opportunity". STE has operations in highly competitive places like France and Germany, whereas Magreb prospects are brilliant, for "some of these countries are like Spain 40 years ago. There is a lot to do and we intend to introduce our products and services there"[21].

The above empirical cases add to the economical analysis of Section 1. The EU has been under corporate focus from the 1960s, when the American companies realized the opportunities associated to the just born EEC. Over the following four decades, the field of action has clearly expanded, encouraging to, or even rushing management reaction.

Section III: The transition from nation-wide to continent-wide type of company

After considering all above, viewing the widest scope of the EU like a single operational unit seems, at least, an attractive proposition. There are four compelling reasons. First, the EU model is overwhelmingly settled. Second, further enlarging steps are ahead, pressed by a number of willing candidates. Third, the agreements with neighboring countries expand the effective frontier farther away. And forth, a growing number of corporations do care about the European proposition. In summary, if the model is willfully strengthening, then it is time for the nationwide type of company to pay attention, too.

How to focus the transition on the part of a company with a fair position in its domestic market, but hardly crossing the border? This section is intended to display a reasoning concerning the steps to follow.

The departing question has to do with the long term viability of a given nationwide business when evaluating two alternative directions: either holding the traditional domestic orientation, or expanding in line with the EU proposition. If holding, than the company is exposed to *foreign* competing forces that may expand into its domestic market and deteriorate its local franchise. If expanding, the feasibility depends on possessing the proper knowledge and organizational conditions. These options suggest three answers.

Answer one is defensive and consists of searching a proper competitor to merge with. The power of the combined capabilities should exceed the simple addition of each one's actual performance. The new entity should have a much greater knowledge in product innovation, manufacturing and marketing.

Answer two is pulling ahead independently, building on own potential. Porter pointed out (1990) that domestic demand and the nature of domestic competition shape corporate competitive capabilities. Then, firms with sophisticated customers and stiff domestic competition are likely to do well when they market their products overseas. Similarly, those that compete successfully in one environment should also be successful competing in overseas environments.

Answer three is mixed. It proposes to keep an independent stance along with setting partnerships for the better management of the successive steps of the value chain, from material sourcing and contract manufacturing up to distribution. The hypothesis here assumed sticks to answer three.

The Management orientation

Then, next is defining the corporate management orientation in two senses: geographical extent and organizational approach.

The *old paradigm* [22]was "Management's [geographical] scope is *politically* defined". It was generally assumed, and largely taken for granted, that the domestic economy, as defined by national boundaries, "was the ecology of enterprise and management". This assumption underlined the traditional "multinational". Increasingly after the 1900, the multinational company derived a larger part of its sales from outside its own country, but "insofar as produced outside its own national boundaries, it was produced within the national boundaries of another country". The country was the "business unit". But the industries of the second half of the century are increasingly run as a system in which all functions are interrelated, but shaping an interwoven system with global view. Therefore, the *new paradigm* states that "the scope of management can no longer be politically defined", for the practice of management "will increasingly have to be defined *operationally* rather than *politically*".

What operational scope are we dealing with? The extended European Map shows three groups of nations economically and politically diverse, but increasingly interconnected. The groups are:

a) *Developed:* The 15-EU plus Norway, Iceland and Switzerland
b) *Catching-up:* The 12 Candidates to join by 2004-2007
c) *Associates:* Turkey, North Africa and the Balkans

They differ in culture, market demand, transaction costs, competitive forces, and partnership chances. However, all of them share, to a growing extent, the same frontier.

In relation to the company's organization, the *old paradigm* [23] was "Management's [organizational] scope is *legally* defined". One reason for this assumption was the traditional concept of management: "command and control". The chief executive of an institution had no authority beyond the legal confines of the institution. This has gradually changed. The Japanese are usually credited for the invention of the *keyretsu*, the concept where the suppliers are tied together with their main customer. However, the *keyretsu* concept was actually invented by William C. Durant, the president of General Motors (GM). Durant begun to buy up and merge into GM one parts builder after another, until controlling up to 70 % of everything that went into a GM car. It was the world's most integrated large business, and the world's most profitable manufacturing company, too. But this type of *keyretsu* "was still based on the belief that management means command and control". That is gradually changing, for the economic value chain "brings together genuine partners, that is, institutions in which there is equality of power and genuine independence". This is the true partnership, the *new paradigm*. It redefines the scope of management to "Management has to encompass the entire process", therefore it "has to be *operational*", therefore focused on the results and the performance across the entire economic chain".

The Organization

That was for management. At the same time, the extended scope demands a revised corporate culture, broadly understood and accepted throughout the organization. It has to encompass the entire system: the internal team and the interaction with outside partners, i.e. suppliers, subcontractors, contract manufacturers, distribution channels and the like.

To bring the new orientation into practice, the internal team should comprise three groups of closely cooperating professional groups, taking care of Business Management, Country Management, and Functional Management [24]Business Management has one overriding responsibility: to further the company's global efficiency and competitiveness, implying the ability to recognize opportunities and risks across national and functional boundaries and, in addition, the coordination of global activities and capabilities. The Country Management plays a pivotal role in meeting local customer needs, being sensitive and responsive to the local market, paying attention to government's requirements, and defending their company's market positions against local and external competitors. The Functional Management provides knowledge and expertise to areas like product developing, manufacturing, human resources, and finance. Finally, the task of the Corporate Management is uniting the three categories in a common purpose, assuring coordination and encouraging learning and building from everyone's knowledge and empirical experience.

Building relationships is the next challenge. The international expansion may increase the risk of discrepancies within the entire business system, resulting from misunderstandings, lack of on time communication, inefficient flow of information, or limited skills in listening, understanding and building upon common interaction. The risk is even higher when incorporating outside partners. In this area, establishing a long term *win-win* approach is an essential condition for continued positive results. The successful companies look for agility, adaptability and alignment within the supply chain, for it is necessary to align the interests of the functional groups and multiple partners, so that they have common values and goals, and move forward in unison. Focusing on cost, flexibility and speed is important, but long term adaptability and success is highly associated to the ability to manage transitions – changing market conditions, evolving technologies and requirements as the product moves through its life cycle[25]. Managing changes, and the corresponding transitions, should better be part of daily life, becoming a routine exercise supported by the organization's ability for analysis, planning and team interaction.

A research [26]comprising 252 Spanish companies (thereof 96 affiliated to foreign multinationals), confirmed three conditions for best adapting to enlarged European relationship and best understanding the dynamics of change. First is centralized decision making, intended to deep involvement on the part of top management in the setting of clear and well supported strategic actions. Second is precise definition of everyone's responsibilities in order to facilitate relationship and interaction. Third is increased communication, intended to open discussion, clarification of propositions, and providing of best inputs for decision making. Furthermore, the best adapted companies are in favor of continued training and quick flowing of information.

The market demand

After discussing the cultural and organizational implications, next is evaluating the market demand. The quantitative and qualitative demand for any company's products may differ in every single market, in accordance with its social and economical parameters. The *Developed* are mature markets, so launching there implies identifying specific niches, competitive advantages, distribution alliances, or a combination of all. The *catching-up* group is highly attractive, for demand will probably keep growing, although particular product and market requirements are to be considered. *Associates* are certainly farther away, but it is time to know them and search for entering opportunities, for commercial agreements and FDI are to lift their economies, making them new *catching-ups.* Turkey is probably the first country to bring into consideration.

Buyer utility and strategic pricing are two underlying sets of economic conditions that successful ideas have in common[27]. This is applicable to both new products and introduction into new markets. There are at least three *utility levers* to fulfill: customer productivity, simplicity and convenience. If there is a compelling reason for customers to buy the product, next is the price persuading to actually go and acquire it. Then, utility levers and adequate pricing do win customers. Strong distribution is the immediate condition, hand in hand with communication via advertising, merchandising and trade promotion.

Competition is a parallel factor. The state of competition in an industry depends on five basic forces: the industry (actual position among current competitors), the bargaining power of suppliers, the threat of new entrants, the threat of substitute products or services, and the bargaining power of customers (the trade). The collective strength of these forces determines the ultimate profit potential of an industry. The knowledge of these underlying sources of competitive pressure provides the groundwork for strategic action[28].

Measuring actual and potential demand, establishing product and market strategies, and surveying competition are key activities for Business Management and Country Management, closely cooperating and building on everyone's knowledge and findings. The Functional Management will then involve in product development, manufacturing and distribution. This internal team activity shall be complemented with outside partnerships for specific functions. All form a system with a determined mission and vision, where all parts are expected to harmoniously contribute to the benefit of the whole.

Demographics plays important role in evaluating the market demand. There is an unprecedented massive immigration and any strategy that is any commitment of present resources to future expectations has to start with demographics[29]. The developed countries of Europe and America have a week pyramidal base, contrasting with the sound position of their modest southern neighbors, like Africa and Latin America. Then, the immigration flow is likely to continue.

A final remark

The reader may find a sign of optimism in the above analysis, especially in 2003, when the EU economy is stagnant, the members find it difficult to agree on a common foreign policy, and Denmark has just refused to adopt the euro currency. At the same time, there are discrepancies in relation to agricultural policies and distribution of development supporting subsidies. The reader may also feel inclined to criticizing the displayed strategic directions. Both reactions are correct. This paper is intended to encourage the corporate and college debate about the EU model and its future within the global scenery. It is also addressed to nationwide companies, encouraging an open analysis of their strategic positions.

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Thinking on Establishing Free Trade Area of Central Asia

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Abstract

With the economic integration all over the world, it is necessary to establish the free trade area of central Asia, including Xinjiang. This paper analyses the demands on establishing free trade area in central Asia. According to the present statues of Xinjiang and five countries of central Asia, the developmental patterns are suggested. Furthermore, some policies and suggestions are proposed about the existing problems.

1. The Need of Establishing Free Trade Area of Central Asia

1.1 The Trend of Economic Integration

World's economic situation has changed greatly since 1980's. Each country in the world participates in the system of international division of labor, which makes the international trade and investment develop rapidly. Therefore the increasing economy of transnational boundaries is coming into being. The integration and internationalization of world economy makes economic relationship among countries come into a new stage of permeating, combining, cooperating and sharing interest each. China and five countries in central Asia stand in the centre of Asia-pacific area and they are major countries that the second longest land bridge crosses and radiates. Japan and Korea are to the east of China and central Asian areas. From the west of China and central Asian areas, people can go to Russia and European countries. Hence central Asian countries play important roles in international economy and trade. Under the background of regional economic cooperation and international economic integration, strengthening the bilateral cooperation and establishing free trade area between north-west of China that is facing the western development and central Asian countries that is eager to develop economy are the needs of times and economic development of them. So to establish free trade area in central Asia will have great effect on economy and trade of Asia and the world.

1.2. The Need of Developing Economy Respectively

The formation of any regional economic group is related to the geographic position, the natural resources, the economic development of every country in the area, the foreign trade, and the economic and technical co-operations among them. Since China's opening up to the outside world, the economy of China's western areas develop rapidly. However, there are great differences comparing with the eastern areas. Under the background of China's entering WTO and the western development, accelerating the economic development of western areas, especially of Xinjiang and making it the new growth point of China's economy are the eager desire of every government in western area. Western areas, especially Xinjiang should cooperate with five countries of central Asia in economy by sharing the common of geographic position, the nationality, the culture and the customs in order to promote the economic development. But five countries of central Asia have not yet free from the crisis since they separated from Soviet Union ten years ago. At present, every country is developing economy gradually though there are many difficulties. So it is necessary for central Asian countries to strengthen cooperation with China, especially with Xinjiang so as to extricate from the economic difficulty.

2. The Economic Cooperation Condition of Five Countries of Central Asia

The total area of five countries of central Asia that includes Kazakhstan, Turkmenistan, Uzbekistan, Tajikistan and Kyrgyzstan is 4 million square kilometers with the population of about 53 million. Five countries of central Asia are integrated in the economic region of the Soviet Union. The infrastructure that formed in the past, the division and cooperation of labor make them close and integrate in economy. Although five countries of central Asia have independed after the break-up of the Soviet Union, the economic condition of five countries worsen because the economic contact with other republic unions is stopped. In order to extricate from the economic difficulty, five countries of central Asia have carried out the economic reform. Each of them determines the policy of opening up to the outside world in all respects to accelerate the economic development. After 12 years' economic transformation, each country has basically established the economic system.

Central Asia that played important role in the history of culture exchange of the western and eastern world is a place that the old Silk Road must go through. Five countries of central Asia have plentiful natural resources and are the base sources of agriculture, raw materials and energy. They have become the region that have tremendous potentiality in economy in world economic structure with wide land, important position, plentiful natural resources, the growing population, the complex nationality composition and the transforming political and economic system, and the ideology although there are many undetermined factors in central Asia.

After the political and economic transformation, five countries of central Asia have focused on developing economy. At the same time, a series of economic legislations are carried and the national cooperation in central Asia is strengthened in order to accelerate the local economic development. The shape that is as an economic cooperation of sub region has formed. In May,1995, the president of Kazakhstan, Kyrgyzstan and Uzbekistan met at Almaata and reached an agreement of establishing integrate economic region. Ten countries such as Pakistan, Iraq, Turkey, five countries of central Asia and Afghan signed DECLARATION and JOINT COMMUNIQUE and decided on establishing free trade area in Istanbul in March, 1995. Five countries of central Asia and Azerbaijan held a second meeting to establish cooperative organization of regional economy like the eastern union. Since 1994, with the promotation of China and every country of central Asia, the intertrade, the economic and technical cooperation have come into a new stage.

3. The Practical Foundation and Condition of Establishing Free Trade Area of Central Asia

The first is the geographic vicinity between Xinjiang and five countries of central Asia. Xinjiang is near to central Asian countries in geographical region. In Xinjiang, the front line is 3500 kilometers. 1700 kilometers of it is adjacent to Kazakhstan, 1100 kilometers to Kyrgyzstan and 550 kilometers to Tajikistan. Although Xinjiang is not adjacent to Uzbekistan and Turkmenistan, it is near to them. Seven of ten frontiers of Xinjiang are adjacent to central Asian countries. By the end of 2002, China has opened up 15 ports to the neighboring countries. 11 of them are trade ports that open up to central Asian countries, which is the exclusive that other countries and regions don't have. In particular, with the link of the new *Silk Road* and the running of the second land bridge, Xinjiang's blocked and hard-reaching transportation are changed and roads to other countries are opened. This is convenient for Xinjiang to cooperate with other regions such as central Asian countries, the west and east Europe in economic and technical cooperation and in trade. Therefore, Xinjiang must become the important passage and material distributing center.

The second is the national understanding of Xinjiang with five countries of central Asia. By the end of 2000, the population of Xinjiang is 19.25 million. The population consists of 47 nationalities. Among them, Han nationality is 39 percent, the minority is 61 percent. 13 of 47 nationalities such as Uygur, Han, Kazak, Hui and so on live in this area from generation to generation. 10 of 13 nationalities such as Kazak, Uzbek and Tajik live in central Asian countries. They share the common in living and nationality customs, religious believes and clothing with nationalities in central Asian countries. The minority nationality of Xinjiang and central Asian countries can understand each other. There are over 300 thousand people in central Asia and western Asian areas, who go abroad from Xinjiang. Many of them concern China's development and often contact with relatives in China. They often exchange each other and trust each other.

The third is Xinjiang is a very important assemble region where China's minority nationality live. Many nationalities in Xinjiang are the same as that in central Asian countries such as Uygur, Kazak, Tajik, Uzbeki and Kyrgyz. Major nationalities' share the common in living customs, traditions, religious believes, languages and characters. Hence they are easy to approve, to understand, to communicate and to trust each other, which are the best privilege for them to cooperate in economy and trade. Since the second land bridge that is 10937 kilometers long from Lianyungang to Rotterdam runs, the old Silk Road has recovered and the transportation of goods and materials have become convenient, which make the trade cooperation easier.

The forth is Xijiang's opening up to five countries of central Asia. China and five countries of central Asia carry out the same policy of opening up to the outside world. Under the guidance of the strategy of opening up in all respects of China, Xinjiang has formed the new economic structure that is along the bridge and depending on the bridge, introducing from abroad and cooperating at home, coming from east and going out of west, sloping down to the western areas. In order to develop economy and extricate from the difficulties, central Asian countries also desire to achieve the aim of economic development by introducing technologies and capitals and striving for economic aids. China's and central Asian countries' policies and strategies of opening up to the outside world lay a political foundation for economic cooperation.

The fifth is the economic complement of Xinjiang with five countries of central Asia. The industrial structure of central Asian countries is irregular. The industries such as petrel chemistry, metallurgy, electric power, traffic transportation are developed but the light industries are less developed. Daily consumer goods such as spinnings and weavings, foods and home appliances are very short. While the industrial structure of Xinjiang is harmonious. The spinnings and weavings and foods in Xinjiang are more developed and have developed into major industries. Agriculture is in a harvest for several years. So agriculture goods are very plentiful. The differences between Xinjiang and central Asian countries have promoted the economic and technological cooperation.

Therefore, from the mentioned above, that is the vicinity of geographic position, the understanding of nationality, the policy of opening up and the complement of economy, I think it feasible to establish free trade area of central Asia.

4. The Developmental Pattern of Free Trade Area of Central Asia

Drawing on the experiences of group development of regional economy in the world, we think the general strategic aim of establishing free trade area is perfect infrastructure, larger scale, harmonious industrial structure and larger central city. The developmental pattern of free trade area of central Asia should be carried out in different stages. It can be divided into three stages:

The first stage is the loose economic cooperation. Every country in free trade further desires to strengthen the cooperation while trading at home or at the frontier. Establishing free trade area in frontier can attract economic resources such as manpower, capitals and materials to cooperate in the international market. Some policies of the developmental region can be coordinated to some degree and economic cooperation can be developed fundamentally. The cooperative pattern that develops economy without reaching an agreement is called loose cooperation.

In this stage, every country need to have a trade relationship based on the frontier trade and have a sound trade net to enlarge the trade scale and decrease the obstacle of commodity circulation. Every country should also need to build important infrastructure, especially to select and construct central cities in free trade area and to build traffic road that links central Asian region to neighboring developed cities and to central cities.

The second stage is the semi-compacted economic cooperation. In addition to carry out the favored policies that are decided in loose economic cooperation, every country in the area should consult widely in policy, sign bilateral or trilateral agreements, reduce tariffs, cancel the trade quotas, cooperate closely in traffic transportation, resources, industrial policies, communications, traveling, commerces and trades, tariffs and develop favored trades each other. At this stage, the most important task is to adjust the industrial structure in all the trade area and build important enterprises. According to industrial privileges and the need of industrial structure, construct new enterprises and reform old enterprises, including constructing and reforming the first, the second and the third industries. In particular, constructing the enterprises of second and third industries are the important part of the strategy because the enterprises' foundation of the second and the third are not sound, some enterprises have no foundation.

The third stage is the free trade stage. Free trade stage is to cooperate further based on the semicompacted corporation. The premise of free trade is to guarantee the sovereignty. Then every country in the area cooperate closely about all the regional developments, signing free trade and tariffs alliance agreements, or building more higher regional economic groups such as common market, economic alliance and so on. Furthermore, a president committee is formed to execute the agreement, to deal with the important questions on home trades, technical corporations, labor corporations, capital flow, resource allocation and tariffs.

Generally speaking, central Asian countries have enjoyed the favorable conditions given by the countries participating in the cooperation because the superegional economic group has been formed. In particular, Xinjiang has made great progress in trading at frontiers and in economic and technical cooperation. And Xinjiang has established economic cooperation region at frontiers such as Yining city, Bele city and Yecheng city. At the same time, China has enlarged trades from central Asian countries to east Europe, west Europe and far east areas while central Asian area have expanded its trades from Xinjiang to west-China, mainland and coastal areas of China. Now there are 20 provinces participating in corporations with central Asian areas. However, there are no agreements in essence between China and central Asian countries. The cooperation between China and central Asian countries is in a transition stage from loose cooperation to semicompacted cooperation. As an imperfect market system of China and central Asian countries, the government and national organization should strengthen the interference and guidance to domestic and local enterprises, corporations, and individual trades. They also should offer chances of cooperation and convenience for domestic and local business organizations. As it a foundation, every country in the area should establish arbitrating organizations cooperatively to deal with trade disputes, to perfect legislations, and to attack all kinds of commercial swindles to reach common understanding in the end.

Therefore, the establishing of free trade area of central Asia is not only good to China and central Asian countries, but also good to economic development of Asia and to the formation of synthesis entity of economic region of Europe-Asia continent center. As a result of synthesis, the economic development of central Asia will accelerate economic development of free trade area of central Asia and neighboring areas and promote economic combinations and mixture growths between free trade area of central Asia and neighboring areas. In the end, free trade area of central Asia will develop into a synthesis entity of regional economy.

5. The Safe Questions on Establishing Free Trade Area in Central Asia

The twenty-first century is an age that world's new situation is taking place of the old one. World's situation is confronting severe challenge. Every country in the world pays more attention to its safety than before. So the international environment that central Asia faces is so severe. Although some political, economic and social foundations, intrinsic necessity and real feasibility lay a foundation for the establishment of free trade area of central Asia, there are some specific questions, such are as follows:

In regarding to political safety, central Asia is in the central of Europe-Asian continent, so the position is very important no matter in history or at present. Furthermore it is easy to be affected by the change of international relationships. Firstly, as developing countries, central Asia countries are troubled with the economic integration of the world; Secondly, with large countries competing each other in the world, central Asian area will be a place that large countries contend for the important strategic position and plentiful resources. Thirdly, central Asian area is a multinational region, so the national relationships are so complex. Recently, three bad phenomena such as the national splittism, religious extremism and international terrorism are rising, which have become a threat to the safety. At the same time, the permeation and impact of external force are also increasing. And there are some interest conflicts between central Asian countries, between central Asian countries and Russia, between central Asian countries and other countries, which are not good to central A sian area's stability.

In regarding to economic safety, under the background of economic integration, world economy develops rapidly and the interdependence of every country increase further. Though central Asian countries have plentiful resources and great potentiality in development, the reform has not succeeded at present and economy develops slowly. Furthermore, as the foreign debt increasing, the technology falling behind, the people's living standards being not high, the society is unstable. Meanwhile, world's economy is not so optimistic. Within ten years, the situation of five countries of central Asia will not change, probably it will worsen. Although there are some economic complement between Xinjiang and central Asian countries, the economy of them is still undeveloped with imperfect law mechanisms and the worried credits. The economic undevelopment will be an impact on the political stability of central Asian areas.

In regarding to the culture, western large countries quicken to permeate central Asian countries by the ideal and ideology of western value. However, with the economic development and increasing power of China and Russia, the safe situation of central Asian area will become better. The reason is that American, Russia, China and other countries all desire central Asian area to be stable in the view of their own interests. At the same time, with the help of international society, central Asian countries strike intentional crime severely. Furthermore, the combination of China, American and Russia is also good to settle regional disputes peacefully.

6. The Suggestions of Establishing Central Asia Free Trade Area

In order to settle existing disputes on establishing central Asia free trade area, we can take measures from such aspects as follows: First, desire China's government to pay more attention to the establishment of free trade area of central Asia and cooperate actively at home and abroad. Next, increase investments in western area, especially in Xinjiang. Accelerate innovation in science and technology, speed up the introduction and cultivation of qualified personnel and give the privilege of local resources play by knowledge economy to strengthen growth motive and international competition of local regional economy.

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Transition Economies' Multinationals - Are They Different From Third World Multinationals?

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Abstract

The article first evaluates the recent expansion of selected Central European firms' outward FDI and compares this expansion with that of the third world multinationals. Differences and similarities are identified. In both cases the most advanced countries proved to be the biggest investors abroad. The motives were similar although there are some differences particularly those that are specific to the system/transition and starting base. Similarities are stronger if we compare the starting phases of both groups of firms. Both groups of investors followed certain stages in which the macroeconomic strategy of the home countries proved to be important. There are also many differences between groups and within them. One is the more important role of pull factors [globalisation] in the case of late-coming investors abroad stemming from transition economies. The scarce data still do not allow any robust generalisations. Some modification at least in terms of the specific weight played by different factors can be identified in the case of Central European investors abroad.

Introduction

So far, when discussing transition most attention has been given to inward foreign direct investment [FDI]. Outward FDI or outward internationalisation has almost been left out of considerations. Nevertheless, since 1997, firms from more advanced transition economies [TEs] have started investing abroad at quite substantial levels even though they were devoid of any previous experiences from the socialist period [see Macmillan 1987, Hamilton 1986, Artisien, McMillan and Rojec 1992]. Firms from certain TEs have now established themselves as major investors in some host TEs. Even now the enhanced internationalisation of firms from TEs has not attracted much attention either, again with few exceptions [Svetlicic's two ACE projects[1] gathering a group of authors, Andreff 2002 and 2003, Kalotay 2003, Liuhto and Jumpponen 2003].

The situation has also been similar regarding the third world multinational companies [TWMNCs]. Only a few authors started in the 1980s to look at the emerging international expansion of the third world firms [Kumar and McLeod 1981, Wells 1982 and 1983, Lall 1983, Khan 1986, Dunning 1986, Svetlicic 1986 and 1987].

Originally the TWMNCs literature concentrated on the "exotic" nature of such corporations. Recent literature has started to look into such internationalisation in its own right; why they expand internationally, what are their characteristics, driving forces etc. [see Mathews 2002]. This is also the case of multinational companies with Central European transition economies [CETEMNCs].

In spite of this benign neglect both types of firms are putting themselves on the map of multinational companies [MNCs]. Third world ones are already competing with the largest multinationals in the world, they are already global firms while those from former socialist countries are still lagging much behind Western companies and TWMNCs. Yet they seem to be catching up quite fast. Therefore, they deserve much more attention particularly since the external environment is quite different which might give rise to some theoretically different explanations. Although the data is still limited, it is nevertheless important to look into such outward FDI trends in order to see to what extent they are different or similar to TWMNCs which developed much earlier at first glance at a similar development level but in different systemic environments.

The aim of this paper is limited to identifying the similarities and differences between TWMNCs and CETEMNCs in different aspects from the timing of internationalisation, the motivations to the type of competitive advantages and the role of the external environment. On this basis we can start exploring some ideas as to whether there can be a general explanation of the internationalisation of less developed countries' firms or whether there is a need for differentiated approaches due to the different internal and external conditions involved. The paper will compare the similarities and differences between CETEMNCs on the basis of our own survey[2] of outward FDI by 5 Central European economies/CEEs [Czech Republic, Estonia, Hungary, Poland and Slovenia[3]], and general data on FDI flows abroad. Secondary sources were used in the case of TWMNCs. We will confine our analysis mostly to manufacturing firms' expansion abroad. The different types of sources and the availability of data prevented the application of any more robust statistical methods. The structure of the paper is as follows. After this introduction stating the objectives, the limitations and background of the paper we proceed in the second chapter to the theoretical framework. The third chapter is devoted to the characteristics of outward FDI by CEEs. The fourth chapter provides a short overview of third world firms' investments abroad merely to set the stage for the fifth chapter, namely a comparative evaluation of the two types of MNC identifying the similarities and differences between the two. The paper ends with some generalisations in the conclusions.

Theoretical Framework

The eclectic paradigm [Dunning 1973 and 1993] predicts that a firm has to possess firm-specific advantages [FSAs] to be able to invest abroad[4], that the foreign location should be better than the one at home and that internalisation is the best mode for the maximisation of such FSAs. The issue therefore is whether firms from TEs possess strong enough ownership-specific advantages to invest abroad, where they can best complement such advantages with location-specific ones and whether they are able to internalise them.

The investment development path paradigm [IDP, Dunning 1981a] postulates that, before investing abroad, countries first host FDI and that investing abroad is a function of GDP per capita. Later it was established that the changing net outward investment position of a country could not only be explained by rising GDP but also by the changing configuration of a firm, location and internalisation advantages and macro-organisational policies. The new version of the IDP model [Dunning and Narula, 1998] postulates that in a globalised world outward FDI starts earlier and the amplitudes of the stages are shorter.

The evolutionary approach of internationalisation is also a characteristic of the Upsalla sequential internationalisation process model[5] [Johanson and Vahlne 1977 and 1990, Johanson & Wiedersheim-Paul 1975] predicting a "normal" sequential step-by-step learning process of internationalisation in stages. Critics of the sequential internationalisation model claim that internationalisation is not necessarily sequential, that 'internationalisation' knowledge can be gained from other firms instead "without having to go through exactly the same experience" [see Eriksson, Johanson, Majkgård and Sharma 1997, Turnbull 1987], and by networking with others [Mattson 1985, Johanson and Mattson 1986 and 1993, Vissak 2000].

The fourth stage of the product life cycle, proposed by Balakhrishnan [1975] in his Ph.D. dissertation, predicts investment among countries at lower stages of development. His argument is that in the fourth, post-mature stage FDI takes place among developing countries and here we can also add among TEs. In the third stage of the product life cycle, technology gets adapted to local needs. Smaller producers acquire certain FSAs based on adapted more labour-intensive technology and by using less standardised local inputs. Large multinationals simply may not be interested in such adaptations, being more preoccupied with innovating new products and/or technologies and/or small, less developed countries' markets are not enough attractive for large firms.

Many studies indicate that management is crucial for the internationalisation of firms and that investing abroad has been strongly influenced by managers courageous enough to undertake such a risky operation at the early stage of their firm's development in the very risky markets of less developed countries [LDCs]. Therefore, outward FDI cannot be explained without looking into [strategic] management theories or "why micro-management superiority of foreign investors over their domestic counterparts is more pronounced when the corporate governance in the host country is weak and financial institutions are not so well developed" [see Razin 2002, p. 17]. This is precisely the situation in TEs where institutions are still weak and their activities not transparent enough and frequently unpredictable. This has two main implications. First, that managerial superiority plays a relatively more important role in the case of investing in transition than in developed industrial countries and, second, that firms from more advanced transition countries have developed transition-management-specific advantages which they can 'cash in' in other TEs still waiting to undergo certain changes [privatisation etc.].

Let us see whether we can agree with L. Wells' old statement that "the theories have done little to answer why firms from developing countries [or TEs for that matter, op. SM] invest abroad" [Wells 1983:13] or whether we should be less pessimistic and conclude that the empirical data do confirm some of the major internationalisation theories indicated above. Mathews [2002] also found the "inadequacy of "most leading theories of TNCs growth and expansion" and offers "a process oriented account of dragon multinationals' transnationalisation in which three key elements are emphasised: outward orientation, leverage through building linkages and achieving organizational efficiency through integration" [Wai-chung Yeung 2002, p. 192].

Outward FDI by Five Central European Transition Economies[6]

Although investing abroad by state-owned enterprises started decades ago in socialist times today it is a totally new challenge. The early 1990s saw slow progress in outward investment activities by large exporters with substantial international experience from the previous regime, whereas post-1997 has speeded up outward FDI also with seeing the involvement of newcomers. Nevertheless, the total stock of the outward FDI of the five CEE transition economies [USD 5.5 billion in 2000] is still very modest. This is, however, only a small part of overall outward FDI by all TEs which had accumulated to USD 29 billion by the end of 2002. The biggest investor abroad is Russia [accounting for 62% of total outward FDI stock by TEs end 2002; [UNCTAD, 2003, P.265], which is a very specific case. Its investments abroad are mostly by natural-resource-based firms and are to a large extent of a speculative nature[7]. Therefore, our analysis will concentrate on CETEs and manufacturing firms.

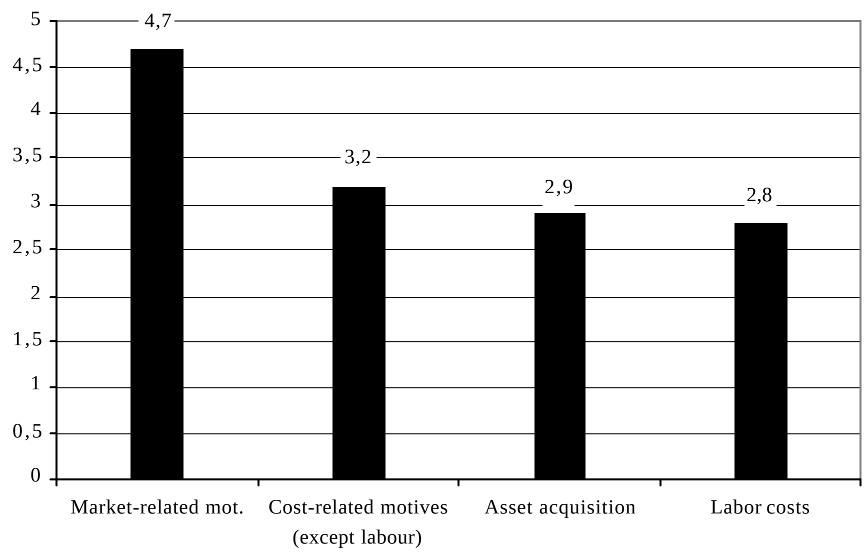
Investors in the sample are nearly 28 years old on average with some dating back even to before World War II, while many are spin-offs of old socialist, now disintegrated companies. They inherited management, brand names and business contacts and can hardly be regarded as totally new firms. Although big companies represent the smallest share of the number of investors abroad, they are the most influential, quickest and most successful in their internationalisation in terms of volumes. Investors are on average large although the majority of sample companies have less than 250 employees.

The majority of outward investors from the analysed countries are manufacturing firms – 51 percent [20 percent are in trade and 29 percent are in other services], which does not necessarily mean that the firm also undertakes manufacturing investments abroad. Trade is the prevailing activity of foreign affiliations, followed by other services and only then by production activity.

The total number of affiliations established abroad by the sample firms was 293 in 1997 and had almost doubled to 477 in 2000.

The gradual enhancing flows of outward FDI following previous exports but jumping over most other forms of co-operation, the distribution of stock and the location of affiliations confirm that the sequential pattern of penetration does matter. Neighbouring countries, countries with strong trade relationships or cultural and/or historical ties have priority in investment location decisions by all the surveyed countries[8].

The market-seeking motive was the most important motive of outward FDI. This is also reflected in the predominance of trade units among affiliations abroad. Investing abroad is regarded as an additional way to keep and increase market shares abroad. Lower labour costs were, on average, the least important motive for investing abroad, also reflected in the modest frequency of locating production units abroad. Even if investing companies decide to produce abroad, lower labour costs are more a facilitating and not a decisive factor. Investors are primarily looking for business opportunities and ways to exploit their ownership-specific advantages, which often have limited time duration.



Note: 1= Not important, 5 = Very important.
Source: Survey 2001

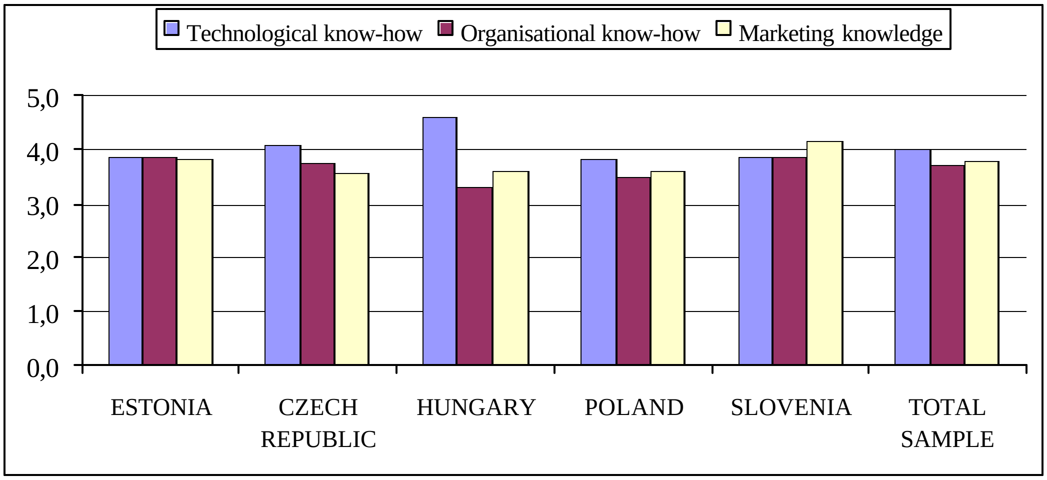
Figure 1 THE IMPORTANCE OF INDIVIDUAL GROUPS OF MOTIVES FOR OUTWARD FDI BY 5 CEE'S FIRMS: AVERAGE SCORES

What Are the Investor's Competitive Advantages?

The reasons for the rapid rise in outward FDI by selected CEEs can be classified into push and pull factors. The two push factors are the existing FSAs coupled with the limited opportunities to increase market shares in existing [small domestic] markets. Firms have realised that by exporting alone they can no longer keep market shares abroad and that they also have to upgrade their foreign presence by establishing subsidiaries there in order to be closer to customers. On the other hand, the march of globalisation forcing firms to 'race costs to the bottom', the need to acquire economies of scale and scope, and the ongoing privatisation and other aspects of less advanced TEs have all been attracting investors to grasp the new opportunities emerging there. These opportunities are also home country location-based due to having once lived together in the same country [Slovenia, Czech Republic, Estonia or minorities' connections in the case of Hungary].

Firms themselves claim that, among the relatively equally weighted different advantages, technological ones were the most important ones, followed by marketing knowledge. There is, however, no systematic evidence as to whether such technological advantages are based on new products or new technologies or more on the adaptation of products and processes to local conditions. In the case of TEMNCs it was more standardised technology [65% of subsidiaries were established up to the 1970s in low research intensity activity; Svetlicic 1987, p. 75].

The second crucial source of FSAs of the investing companies surveyed is the management of those companies. The capabilities of the managers who undertook investments abroad before the theory would have predicted, that is before all the necessary capabilities are accumulated, have been crucial. Managers have frequently demonstrated a strong vision at times when investing abroad was considered unpatriotic or at least unusual [in socialist times and the first years of transition]. Some managers have developed a very specific management style based on personal contacts and highly assimilated to the culture of the host countries.



NOTE: 1= not important, 5=very important
Source: Survey on outward FDI in CECs, 2001.
Figure 2 THE IMPORTANCE OF COMPETITIVE ADVANTAGES BY COUNTRIES

On average, organisational know-how, as a specific type of FSAs, was assessed as somewhat less than 'important'. However, the case firms claimed they have developed specific management advantages partly as result of faster privatisation compared to the core destination countries. This type of advantage is temporary. Firms have to exploit it fast, before other competitors can catch up or outperform these advantages through other stronger competitive advantages. It is therefore crucial to achieve a *first-mover advantage* already in the rebuilding phase of these countries and to upgrade other advantages before the advantage of how to do business in a specific environment expires.

The more risky environment found in other CEEs, less stability and predictability make firms choose FDI [internalisation] as a safety-net solution in spite of the larger sunk costs. One incentive is to achieve the better protection of intellectual property, which is still very poor in this region. Companies have found it easier to control their intellectual property and defend their original products against imitations when they have a direct presence [see Jaklic and Svetlicic 2003].

The Greenfield investment [the majority was totally owned or majority owned] strategy that dominated in the early and mid-1990s was later combined with an acquisition strategy. The explanation of the desire to acquire control is not so much a reflection of their strong FSAs but of some weaknesses, the unavailability of appropriate partners abroad or different uncertainties. Privatisation processes and the favourable prices of companies available for acquisition were the key reason for this. The rise in acquisitions after 1998 was also easier because the acquisition process in the domestic market had gained some momentum.

Third World Multinational Companies

The first internationalisation of third world firms dates back to 1928 when the Argentine manufacturer S.I.A.M. di Tella established a subsidiary in Brazil to produce gasoline pumps [Wells 1983, p. 1]. But this was more an exception than a rule. Real internationalisation started in the 1960s [see Wells 1983, Lall 1983, Kumar and McLeod 1981, Khan 1986, Svetlicic 1986, Dunning 1981, White 1983, and Tolentino 1992].

Dunning and Narula [1998] and Chudnovsky and Lopez [2000] distinguish three waves of such outward FDI by third world firms. The first wave started from Latin America in the seventies. It was going on alongside an industrialisation strategy based on import substitution in home countries. Latin American MNCs have spread abroad thanks to products meeting the needs of their growing domestic markets. The second stage is markedly characterised by predominant Asian MNCs in the eighties, namely those from South Korea, Taiwan, Hong Kong, Singapore, and then Malaysia, Thailand, China, India and the Philippines, while Latin American MNCs have stepped back relatively. Outward FDI from Asian newly-industrialised countries [NICs] accompanies their home country strategy of export promotion, growing markets in LDCs but also in order to benefit from the cheap labour there. The third stage, in the nineties, exhibits the recovery of Latin American outward FDI in the context of globalised competition in all manufacturing and service industries, on one hand; whereas on the other hand the biggest Asian MNCs now compare to and compete with Western MNCs as demonstrated by their investments in developed countries [see Andreff 2003, p. 19]. Chudnovsky and Lopez [2003] found in such development a confirmation of the IDP paradigm, as did Andreff [2003].

As in the case of CETEMNCs we also obviously have wide heterogeneity among TWMNCs. They differ in terms of the timing of their internationalisation as well as the characteristics of their competitive advantages, motives or other characteristics [see tables]. What is also important to note here is that the general development strategy, a kind of systemic characteristic, also proved to be highly important for internationalisation as clearly demonstrated in the case of Asian and Latin American firms originating in totally different strategic backgrounds like the system had been in the case of TEs.

Comparing Third World and Central European Transition Economies' Multinational Companies

Both groups of countries are so heterogeneous that any comparison is highly subjective and could be highly biased. The most important general conclusion is that there are many more similarities than differences in internationalisation development between the two groups of countries' firms although TE lags 31 times behind in terms of outward FDI stock. Therefore, it is not surprising that many authors researching into both phenomena confirm the validity of the IDP paradigm since both groups of countries firms investing abroad do share many similarities in terms of the timing of internationalisation, its evolution [by stages] and development level. LCDs' outward FDI stock was at today's TE level approximately 20 years ago.

Table 1 KEY DATA AND CHARACTERISTICS OF THIRD WORLD AND CENTRAL EUROPEAN TRANSITION ECONOMIES' MULTINATIONAL COMPANIES

	TWMNCs	CETEMNCs
Beginnings and developments	Three stages: a) 1960s to 1970s, mostly L.A. firms; b) 1980s [Asian firms] ; and c) 1990s onwards. [see Wells 1983, and Chudnovsky and Lopez 2000] External incentives; ASEAN integration Incremental expansion [Matheus 2002, p. 192] Exports preceded in 85% cases outward FDI [Wells 1983, p. 68]	Three stages: a) pre-transition infant stage; b) early beginning till 1996; and c) Real upswing after 1997. Specific system escape motivation in socialism [Svetlicic, Rojec and Lebar 1994] or institutionally-based [Andreff 2003, p. 10] Later EU integration accession, and increased globalisation pull factors, exports almost always the first step before FDI
Data on OFDI and	Stock 2002 for all developing	stock 2002 USD 29

MNCs	countries USD 849 billion[9] [UNCTAD, 2003, p. 264] USD 5-10 billion by 1980s [Wells 1983:2] USD 29-34 billion estimated stock of FDI by selected LDCs in 1982 [Dunning 1986] 1,964 subsidiaries abroad but estimate goes up to 6,000-8,000 [Wells 1982 and 1983, p. 2] 1% of outward FDI stock in 1960, 3.2% in 1978 and 11.9% in 2000 [Andreff 2003, p. 18] USD 23-26 billion of Inter- Arab and Arab investments in other LDCs [Svetlicic 1987, p. 22]	billion for all TEs [UNCTAD 2003, p. 265] USD 1,483 million in outward FDI by PETs[10] or 0.1% of world outflows of outward FDI in 1990 [Andreff 2003, p. 4] USD 2.5 billion in outward FDI stock of 5 CEEs in 1997 increased to USD 6 billion in 2001 [Svetlicic and Jaklic 2003[11]] 863 affiliates in developed countries in 1992 [Andreff 2003, p. 4, 10] outward flows from TEs increased from 0.29% in 2000 to 0.56% of total worldwide flows in 2001 USD 20 billion in 2000 or 0.38% of world outward FDI flows [12] [Andreff, 2003, p. 7]
Ownership of subsidiaries	JVs and 100% owned [57% in manufacturing; Wells 1983, pp. 3 and 108] In other LDCs mostly joint ventures [90%; Svetlicic 1986, p. 80], 65% of subsidiaries in other LDCs private, 20% state 15% mixed [based on Wells' data bank, see Svetlicic 1986, p. 81]	Mostly 100% owned and greenfield
Ownership and type of investors	Mostly private large, old firms Only 6 qualify for large MNC having more than 6 manufacturing affiliations abroad [Wells 1983, p. 9] 43% of investments in other LDCs are small, 20% medium and 16% large [Wells' data bank, see Svetlicic 1986, p. 77]	Originally state-owned trading companies After transition private or mixed Mostly manufacturing firms but expanding in trade Major investors by capital invested are large old /experienced firms while by numbers SMEs prevail
Type of activity	Trade units [Wells 1982] In other LDCs mostly manufacturing [Wells 1983] Now some real global firms	Sales units prevail pre and during transition Production units more of a client-follower type to preserve [export] market

		positions
geographical orientation	High regional concentration [Wells 1983, p. 4] Mostly other LDCs, increasing in ind. countries	In socialist times advanced countries [system escape and export promotion] and production in LDCs [also political motives] Now high regional concentration in less developed and neighbouring TEs
Transnationality index	39% for 50 biggest TWMNCs and 53% for largest 100 [UNCTAD 2001]	32% for 25 biggest MNCs from TEs in 1999 [UNCTAD 2001]

In both groups of countries large firms are the dominant investors abroad and flows are highly concentrated within the region. That also applies to inter-Arab investment which is much less known among those within the developing countries group [see Svetlicic 1987]. In both groups of countries systemic characteristics play an important role in the internationalisation of their firms albeit for different reasons. Socialism was to a certain extent a push factor for internationalisation while in the capitalist economies of developing countries' firms there were more limitations to the full functioning of market economies. In most countries the exporting of capital was initially de-stimulated if not prohibited. Many countries restricted imports [even by quotas], which stimulated firms to circumvent such barriers by tariff factories in such countries. Market-seeking has been the major driving force behind internationalisation together with other home country push factors.

Table 2 MOTIVATIONS

	TWMNCs	CETEMNCs
Motivation	Originally systemic based, avoiding quotas... [Wells 1982] Market-seeking less important [large domestic markets the most important], acquiring strategic assets, improving responses to customers, lower labour costs as a defensive instrument [against the introduction of quotas; Wells 1983, p. 78] Diversification of risks [Wells 1983; p. 68]	dominantly market-seeking outward FDI [small domestic markets], but also strategic-asset-seeking, and other lower labour costs as a defensive instrument [against the introduction of import limitations due to huge trade deficits by host countries; utilisation of temporary FSAs [knowing how to do business knowledge]
Domestic push factors	Major determinants of outward FDI Home country factors push internationalisation Later own innovations with industrialisation which also became a push factor [Tolentino 1993]	Small domestic markets a major determinant of outward FDI Bad domestic investment climate, prohibitive taxation, political instability and high inflation and circumventing export quotas [Andreff 2003, p. 18] Exploitation of specific

		knowledge and brand names reputation
External pull factors	Less important than internal factors Regional integration schemes	More important than in the case of TWMNCs due to enhanced globalisation and other external changes including accession to the EU

Similarities in motives should have led to similarities in strategies as well. However, one can see more differences in strategies than in motives. The Balakrishnan hypothesis [see theory] has proved quite relevant to both groups of countries [relatively more in the case of early TWMNCs], meaning that it may be of [temporary] relevance in the infant stages of internationalisation. Firms start by building on advantages more in areas Western multinationals are not interested in pursuing, more on assimilating or adapting their technologies but simultaneously upgrading their own specific advantages although initially more in organisation, design than of totally new quality products. TWMNCs are much more advanced in their domains but there are signs that CETEs are following in their footsteps and will, because of their better starting level, soon catch up and start evolving as truly global companies. At the moment, they are more oriented to becoming regional multinationals.

The eclectic paradigm clearly states that investors must have some FSAs in order to qualify to invest abroad.

Table 3 ADVANTAGES AND STRATEGIES

	TWMNCs	CETEMNCs
Competitive advantages	Location-specific, some brands, small series, adapted technology, cheaper overheads [managers' salaries are lower], more use of local inputs products/services more suited to the local environment [Wells 1983, p. 48] Specific skills in marketing, productive or technological knowledge [Lall 1983a] Intensive-intensive technologies and small-scale production [Lecraw 1977, Wells 1983, Agarwal 1986] Innovations in strategy and organisation [Mathews 2002, p. 191] Tapping into external advantages and networks [cellular »clusters« among strategic units of dragon multinationals, efficient managing of them [Mathews 2002, p. 192] FSA are changing along the IDP from the adaptation and assimilation of technology towards more own innovative FSAs [Cantwell and Tolentino 1990]	Macro-location-institutionally-based [politically the same systemic background] knowing how to do business in a similar environment, established networks based on previous [export...] co-operation Cultural vicinity, languages
Strategy	Cost- and following-the-customers based [Wells 1983, pp. 54 and 63]; Adaptation of products/processes to fit the prices and quality requirements of LDCs; Niches abandoned by conventional TNCs [Wells, see Chudnovsky and Lopez 2000, p. 37]; Ever increasing inclusion in global production chains; No specific international strategies until the late 1990s;	Defensive, defending previous export markets; Following the [industrial] clients supplying intermediate products; Efficiency-seeking strategy [low wages] very rare but growing [see also Andreff 2003, p. 17] regional trading multinationals; leapfrogging internationalisation, even some born globals No specific international strategies until the late 1990s

Comparing investors from the third world with those from TEs demonstrates there are substantial similarities particularly if we compare the initial stages of such investments. New entrants among investors abroad can hardly compete on highly sophisticated technologies or know how if they come from less developed countries as is happening with firms from former socialist countries or more advanced third world countries. Both firms gradually upgrade their FSAs from more assimilated adapted technologies to the specific conditions of investment destination-countries to more original innovation-based knowledge[13]. The process of such upgrading was faster in Asian countries because outward-oriented development strategies and targeted industrial policies forced firms to meet targets in order to qualify for specific assistance. Import substitution strategies of Latin American countries dissimulated such efforts so it is therefore no surprise that they started to lag behind internationalisation after their initial pioneering role. Former socialist firms have found themselves in a similar situation to Latin American countries, living behind high-protected tariff walls. Very few firms with ambitious and visionary managers, in spite of such protection, started to strengthen their capabilities and invest abroad, even in the 1960s. Now the process of the catching up of "dragon investors" is very rapid due partly to the better starting position of such firms in terms of technical manpower. Therefore, we can expect that CETEs' firms will soon join the many TWMNCs first as regional [as they did first] and also increasingly as global players. Membership in the EU will also stimulate this process. It seems that a certain convergence is also going on in strategies where lower labour costs have not played a major role. Erosion of its role by technical change can only be one explanation today.

Differences

The huge differences within both groups of countries make comparisons very difficult and prevent any reliable generalisations. Firstly, there is a huge difference in the number of countries and the size of their economies. MNCs from Latin America are quite different from those from Asia. TEs' firms also differ in terms of the development level of countries, their size, stage of EU membership, privatisation and previous development strategies. Firms from small countries are more driven into going international than those from large ones like Poland or Russia.

The stronger involvement of small and medium-sized enterprises [SMEs] in the case of CETEMNCs can be traced to macro location-based factors, previously established networks in the common market of now disintegrated countries. Previous experiences of managers of the larger state monopoly firms which later established their own firms but inherited all the experiences and networks from previous international businesses is an additional explanation. The new information technology infrastructure also makes it easier for SMEs to internationalise today, particularly as suppliers to large MNCs [client-driven internationalisation]. It was not so important when integrated global production was not as advanced.

The timing of the starting period of internationalisation was also different. TWMNCs started earlier, in the 1960s, while only very few firms from socialist countries started to invest abroad then. The time lag of the internationalisation of CETEs' firms is therefore about 25 years[14]. After 1997, the internationalisation of CETEMNCs seems to be faster, firms are leapfrogging over stages, some can even be considered born globals. This can be explained: i] by globalisation pull factors which are now much stronger than in the period of the first wave of TWMNCs' expansion and when electronic communications make it easier to internationalise; and secondly ii] due to better human capital capabilities. It can be expected that within some 10-15 years the convergence particularly of firms from new EU members will come about.

Due to the specific historical context not so few CETEMNCs have evolved as "inherited investments" [Svetlicic and Jaklic 2001] or what Andreff called "institutionally founded MNCs" [2003, p. 10] established overnight as a consequence of the disintegrating of countries in which those firms operated before. In this way such firms evolved from large domestic firms to small international ones by the simple new political reality. Ethnic ties are much stronger in the case of Asian TWMNCs than CETEMNCs. The large Chinese population outside of China and strong traditional family ties in their society make ethnic ties much more important. There are minorities outside homelands in CEEs but they are not so strongly or traditionally interconnected. They more facilitate than induce outward internationalisation in infant stages.

Trade names have not proved to be a major driving force for outward FDI by either TWMNCs or CETEMNCs, although they are not nonexistent. Its relevance is of a somewhat different nature. TWMNCs initially designed some brand names to serve the specific tastes of developing countries' populations [now already global brand names] while, in the case of CETEMNCs, we see more the exploitation of general brand names of investors established originally by exporting [customisation]. This is more the defence of existing brand names by upgrading entry methods when threats of import limitations emerge while in the case of TWMNCs we can talk more of the offensive penetration of brand names first suited to local tastes, and later also of a global nature. CETEMNCs are also less inclined to regard their FDI as an instrument of the differentiation of risks while this argument is stronger in the case of TWMNCs.

The ownership structure of subsidiaries abroad also differs: TWMNCs are much more keen to enter into JVs with local partners [see Wells 1983:115] than CETEMNCs which firms have wanted to control their operations abroad [partly out of weaknesses not strengths, [see Svetlicic and Jaklic 2003]. Explanation is partly system-specific [late privatisation in host countries, non-transparent systemic conditions and other instability] which would increase risks in the case of shared ownership. The other explanation is the type of FSAs. They are similar to those a local partner might bring in to a venture therefore there is no need to acquire them. The summary relative weight of the different factors of internationalisation is different although similar factors play a role.

Conclusions

The lack of reliable data and the heterogeneity of both groups of countries prevent us making any robust generalisations. Investing abroad is a relatively new phenomenon for TEs' firms. Therefore, it is also too early to draw generalisations although a more robust test of the IDP model on the two groups of firms has confirmed there are no significant differences among them in terms of sequencing internationalisation [see Andreff 2002, p. 377]. Comparing CETEMNCS with TWMNCs 20 years ago we can find several common features. Similarities prevail over the differences, which may indicate that outward internationalisation is less systemic, but more specific to the macro development level, location [transition] and firm[15] and is more contingent on external environment conditions.

In the early eighties, TWMNCs were comparatively small, their small-sized foreign affiliates were less numerous than those of Western MNCs and less scattered over a great number of host countries, like MNCs from TEs are today. In Latin America the small size of the home country and domestic market is a factor pushing local firms to invest abroad so as to enlarge their outlets [Chudnovsky and Lopez, 2000, Andreff 2002, p. 375]. The internationalisation of CETEMNCs was pulled more by the external environment and globalisation trends than pushed by home market factors. FSAs are largely location- and system-based and originated in a common history or in similarities of systems, cultures/languages and related factors. Many of their competitive advantages could gradually "evaporate". Therefore, firms are stimulated to start exploiting them very fast [first-mover advantages].

It is beyond serious doubt that CETEMNCs have established themselves as new players in the global reconfiguration of the structure of industry and services in the world and the ways in which firms pursue their objectives and by newly slicing their value chains. For some authors internationalisation by firms from less advanced countries only confirms the mainstream FDI and internationalisation theories. There are, however, also differences which may call for new theoretical approaches. Differences are more systemic and transition based. It seems that a certain productive combination between the Reading school and evolutionary approaches to internationalisation [the Scandinavian school] is needed which could result in a "leapfrogging eclectic investment path paradigm". Although TEs are still confined to more competitive "national champions" and/or a small number of new entrants are still relatively small, they are likely to be developed faster than TWMNCs which needed some 20 years to enter the really big league because TEs' inherited stock of capabilities is bigger. It seems that vertical integration, following the client-driven type of internationalisation, of vertical efficiency-seeking may prove to be the most dynamic dimension of the internationalisation of CEEs' firms in the future substituting today's prevailingly market-seeking defensive operations, defending previously attained export markets.

To conclude, it is still impossible to say whether CETEMNCs are a totally new "animal" substituting the previous "red multinationals" [Hamilton 1987]. There are not yet any clear-cut robust data to confirm or refute that such multinationals have their very specific characteristics or even that new theories are needed. Much of such outward FDI is still associated with capital flights, are related to transition instability and cannot be explained by deeply rooted economic rationale alone. Western multinationals needed several decades to grow into real global companies. The third world ones needed a much shorter time to become world competitors albeit they are still lagging behind the Western ones. The question is whether firms from transition economies will need even less time to become real multinationals. Our research seems to confirm this prediction.

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End Notes

[1] This resulted in two books, Jaklic and Svetlicic 2003, and Svetlicic and Rojec 2003.

[2] The survey contains data on 168 investing firms in 2000 with 477 subsidiaries abroad. In the absence of ready-made national statistics in transition economies on outward investing this was the only reliable source for qualitative but also for most of the quantitative data.

[3] When available and appropriate we will also refer to internationalisation by other TEs, particularly Russia which is a major investor abroad in terms of volume.

[4] Similarly also the resource-based [based on Penrose, 1959] and evolutionary theories of internationalisation [Cantwell 1989 and 1994; Lall 1993, Kogut and Zander 1993, Wernerfelt 1984, Rumelt 1984] argued that a precondition for investing abroad are resources and capabilities and that the accumulation of firm-specific advantages is a cumulative process.

[5] Based originally on Carlson [1966] also called the Uppsala Internationalisation process model or Nordic school or Stages Theory of Internationalisation. Broadly speaking, it is also based on behavioural theory of firms [see Aharoni 1966].

[6] Based on Svetlicic and Jaklic 2003.

[7] Much of outward FDI refers to “round-tripping” [see Kalotay 2003, p. 14]. According to Liuhto and Jumpponen, the recorded outward FDI stock of Russia is some 10% of capital flight.

[8] Slovenian outward FDI is concentrated in the successor states of former Yugoslavia, Czech’s in Slovakia, Hungarian’s in Czech Republic, Slovakia and Romania [strong national minority], while Estonian outward FDI gravitates towards the Baltic countries, mostly Lithuania and Latvia.

[9] Latin America and Caribbean 173, and Asia USD 632 billion.

[10] Data refer to post-communist economies in transition [PETs].

[11] If not otherwise stated, all data on 5 CEECs are based on Svetlicic and Jaklic 2003.

[12] Data refer to post-communist economies in transition [PETs].

[13] At first it is mostly organisational.

[14] The stock of outward FDI by TWMNCs was then similar to that of CETEMNCs today.

[15] It is interesting to note that Indian firms also started to invest abroad in the mid-1990s. This may confirm the importance of external factors [globalisation] as well as the development strategy starting to be more outward oriented. There are also striking similarities in terms of the sources of FSAs [see Pradhan 2003].

Opportunities and Vulnerabilities in Mercosur: Looking for Room for Peripheral Regions

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Abstract

Over the last years the Center for Latin-American Studies (NEAL) of our University has been focusing on the analysis of the prospects for consolidation of Mercosur. One of the results of that effort was a book, published last year[1]. The team, in association with researchers of the Catholic University of Uruguay, is now concentrating on the impacts of the Block's implementation upon the less-developed regions encompassed by it. The fulcrum idea is that such consolidation process creates a new framework of microeconomic conditions, which might offer new business opportunities, by means of changes in the operating environment of some production chains in those regions and, at the same time, can also endanger viable schemas presently in operation. This paper sums up some relevant findings from our previous work and presents the justifications for the present study. It describes our first steps towards establishing an adequate approach to analyze the changes in the microeconomic framework, and to try to detect new opportunities and vulnerabilities.

I. Introduction

The debate on how to improve the state of our economy, and the prevailing social conditions in general, has been long attracting much attention. The majority of the efforts are directed at defining postures and activities that, most of the times, are fundamentally linked to our domestic reality. As regards the rest of the world, the predominant themes are related to our connections with the central countries and with the institutions led by them. At the same time, and rather as a political and personal effort of the President, the subjects of Mercosur, and the need for some other kind of integration in Latin America, have been emerging more often recently. This text intends to discuss some aspects of this third focus of attention, without any concern as to ranking them by their order of importance. In this item, we will refer to some results of a previous work of ours and, in the following ones we will describe the first steps of a research we are at present carrying on.

At the beginning of 2002, in a period of widespread discredit relating the possibilities of consolidation of Mercosur, we decided to study this theme, focusing exactly on the specific difficulties related to the stability and continuity of the block. The starting point of the study was the consideration, from an economic point of view, of the type of structure of correlation of forces, which characterizes the relationship among the countries of our block. Such relationship is bipolar, and thus different from those prevailing in other economic blocks, as in NAFTA, which is unipolar, and in the European Union, multipolar. To analyze the implications of this background, we used qualitative elements of the Theory of Games, as well as elements of recent contributions to the Theory of International Economic Relations.

A Theory of Games' model, that foresees the possibility of one, or some, of the players becoming "Veto Players" (or "Dictators"), was applied, to explain why this bipolar structure of correlation of forces has been constituting, over the last years, an additional problem, even if not the most important one, for the consolidation of Mercosur. Clearly enough, the two poles are Brazil and Argentina. If we accept that such configuration of correlation of forces, among the countries that now constitute Mercosur, is one additional stumbling block in the way of its consolidation, then we should try to suggest some way to overcome it. As we concentrated on the core of the problem, an idea arose naturally and led us to discuss a different arrangement for the regional integration. The proposal consists of moving as far away as possible from the present situation, evolving to a new format that, at least from the point of view of the Theory of Games, would be approaching the multipolar configuration of the European Union. This would be achieved by means of the amplification of the number of elements in the group. That is to say, it would mean striving to involve, as soon as possible, more South American countries - all of them, if possible - in the arrangement, within a more flexible structure, forming a broad block of economic cooperation.

Even so, and in the same way as it happens in the European Union, there would be countries that are much larger than the other ones, but, in case one of these decides to leave the coalition, the rest of the group would still be large enough to ensure the block's feasibility. This would reduce both Brazil's and Argentina's individual muscle - their veto power - and could facilitate the overcoming of deadlocks. Evidently, these two countries would continue to have expressive economic weights, but, from both an economic and political point of view, the decisions could be mediated by the participation, and even pressure, of the group of smaller countries. It is interesting to note that this same conclusion has been arrived at by many analysts, although, obtained through different approaches. Also, it is necessary to make clear that we are not, of course, considering here the premature admission of another potential "Veto Player", with far more individual power, implied in an anticipation of ALCA.

Another aspect that we remarked was that in a structure like that, bipolar, which we suggested should be driven closer to a multipolar one, the existence of supra-national institutions, with real power to monitor the economic relationship among the countries, inhibit distortions, arbitrate divergences and, above all, direct, as required, compensatory financial flows, enhances to a great extent the likelihood of advances in the integration. The European Union offers good instances of operation of such mechanisms. Several of its successful endeavors vindicate the validity of the use of "lateral payments" as a mechanism to help to achieve and maintain stability in coalitions, as foreseen by the Theory of Games.

As concerns these supranational structures, the first move to come to mind would be to copy the model of the European Union. Indeed, it is a rich experience that should be studied and that will, no doubt, collaborate with inspirations for Mercosur. However, the discussion on what to do in relation to this subject should take into account the understanding that there are heterogeneities within each block, with respect to the real conditions of the member countries. Furthermore, their ranking of priorities and goals will not always be the same, which implies differences among the blocks, regarding which arrangements can be more efficient to obtain success in each case. Thus, the European Union can be useful as a blueprint, or even present elements that could be adapted to Mercosur conditions, but should not be taken as a formula to be adopted in its totality. The ways of Mercosur must have the hallmark of its specificities.

Indeed, when Mercosur was conceived, its creators proposed a schedule to be followed in its establishment that, in relation to several aspects, would be, roughly, a copy of the model of the process of constitution of the European Union. For many reasons, this seems to us to have been a mistake. One of such aspects refers to the sequence of phases foreseen in the agreement. We believe that this was not an appropriate choice, if the specificities of the countries involved are taken into account. That is so because, on the one hand, it contemplated a rather bold and quick schedule of advances, in what concerns the legal and political structure of the block, as well as some economic changes; and, on the other hand, it did not determine the development of supranational structures. This unbalance is a problem for the block, and we consider that the retaking of the project demands immediate actions in the sense of reconsidering this model. In one front, in order to rapidly create those structures and in another, for turning the arrangement more flexible, incorporating only the mechanisms those are useful to fulfill the requirements arising from our specific situation.

It seemed to us, then, that the creation of these supranational structures is a far more indispensable and urgent step, than, for example, the establishment of a Latin-American parliament or a common currency, so often raised by politicians. The reason is that it is likely to bring about the desired results more quickly than the first of the latter and, being broader than the second one, it will be able to deal also with other problems, besides the monetary ones, facing and trying to minimize turbulences[2].

As it relates to turbulences, it is worth reminding one of the advantages of the constitution of blocks, one that is usually less commented, but very important at the present to all countries of an enlarged Mercosur: in times of great volatility, there have been many cases of crisis in our economies caused by events generated out of our subcontinent. The unipolar structure prevalent in the world context, also in terms of hard currency, propitiates this to a great extent. In contrast, the supranational structures can, and should, stimulate the growth of the volume of intra-block trade, because, as it is known, this decreases our need, and dependence, of hard currencies, and therefore gives us a better degree of insulation from certain turbulences.

But there is another development, even more daring and promising, that such a structure might provide and guarantee, so as to turn the project into a source of more sustainable dynamism. We are referring to the negotiation and establishment of more stable prices, or terms of trade for the more strategic commodities and services traded among the countries of the block. It is strange that we buy gas from Bolivia, oil from Venezuela and Argentina and electric power from Paraguay and, at the same time, these countries buy from Brazil several goods, many of which "commodities", and that all of these goods are priced in US dollars. This brings instability to our countries, every time the value of this currency oscillates, due to the most diverse, exotic and distant reasons, generated out of our area and, certainly, falling out of our control and responsibility. Thus, the existence of special agreements of intra-block trade conditions could lead to steadier and durable bases, providing more viability for the planning and for obtaining of a sustainable development.

If, from the beginning, all of these measures seem to be more beneficial to Brazil than to the other partners of the block, on the other hand this country will certainly have to accept the role of contributing more heavily with funds and resources for the "lateral payments". And, there is a lot that can be done based on Brazilian initiatives, if the decision of really supporting our partners' development existed. The crisis is by no means a valid excuse for the inertia regarding this issue, not least because it is through undertakings (in a Keynesian sense) that crises can be overcome.

Financial, material and technological resources that are capable of solving crucial problems affecting member countries can be mobilized taking Brazil as a base. Of course it is not meant that the Brazilian State would take upon itself all the responsibilities. Even though the government does not have enough resources for that, its action, participation, interest and guarantee, can be decisive to mobilize private agents, both Brazilian and/or regional, in addition to supranational financing institutions, and together with the partners, raise the means to accomplish important achievements. At last, there is no point in 'beating the bush', Brazil can and should take, together with other countries that are ripe for it, initiatives to launch that process. Exempt of any purpose of dominating, or even leading the block, we must understand that the magnitude of our effort, as well as the sheer size of the country, will end up being proportional to the results that we will be able to reap.

Still in relation to our book, it comes out with other findings, derived from the analysis of the reality of the ways of operation of Mercosur in the last years, which are worth mentioning, as they shed light on some features of the concrete situation, and reinforce the reasons for the new study that we are developing. Such findings are the following:

1. The examination of the data of the intra-block trade, during the “good times” of Mercosur, shows beyond doubts that there is a great deal of complementarities among the four countries’ economies, portrayed in the significant increase in their exports. Each country takes advantage of its comparative advantages, in the industries in which it is more competitive, and benefits from trade. It is known that there are conflicting issues, but those are circumscribed. In relation to each one of the countries, it can be argued that:

2. A substantial share of Brazil’s exports to Mercosur involves manufactured products, whilst its imports are, mainly, of primary products, along with and “transport equipment”. This fact can be explained by the higher (broader) level of integration reached by the Brazilian industrial sector, as compared to the other countries of Mercosur.

3. As for Argentina, the list of goods exported comprises mainly primary products, one important exception being the automobile industry. Its imports are, in their majority, manufactured products. One can understand this fact by recalling the de-industrialization process, which Argentina went through during the last years, and its specialization and higher efficiency in the production of primary products, among them oil.

4. The economies of Paraguay and Uruguay share some similar characteristics: both of them export primary and manufactured goods with low technological density and they also import primary products and, in a smaller scale, manufactured products. These are less industrialized countries, which found a large market for their primary products. They import manufactured products because, due to scale limitations, they could hardly reach advanced levels of industrialization.

5. On the basis of the data referred to above, we can perceive that, in spite of many positive movements, Mercosur’s operation didn't manage to bring about substantial changes in the internal logic of development of each country. Obviously, this would not be modified just by the existence, even if more efficient, of Mercosur, since such features

are also heavily marked by the influence of a historical and economic past, as well as of the rest of the world. Just to give an example, the fact that Argentina imports manufactured products and exports primary products is due to the process, referred to above, which this country has been experiencing since the decade of 1970, and which led it to become not very competitive in the industrial sectors, but very efficient in the production in the primary sector goods.

6. These facts reinforce the argument we have put forward, concerning the need to implement some kind of compensation payments among the countries of the Block. Such schema would allow for counterbalancing part of the problems commented above, and some others as well. There are situations whereby countries that export products of higher technological content may be reaping the larger benefits stemming from higher added values, which lead to increased disadvantage for smaller countries, as well for those with lower degree of industrialization. A concrete fact to be faced, in this context, is that the two smaller countries have never been able, during the years of full operation of the Block, to decrease their negative trade balance, in relation to the rest of Mercosur.

Conscious that the discussion concerning the strategic importance, for Latin America, of the consolidation of a regional block, and the difficulties to reach it, is not exhausted - not least because the reality changes every day - but, also, that there is already some clearness as regards the general lines of the problem, we decided it was time to begin another investigation. It would already be an opportunity for us to redirect our attention to a specific aspect of this issue, which concerns the peripheral area where we live, the Brazilian Northeast. This is the object of our current efforts and its discussion is presented in the following sections.

II. Justification for the new study

It is only natural that the majority of the current panorama's analysis, as well as of the prospective studies, regarding the economic relationships among the member countries of Mercosur, have focused, both in space and industrial sectors terms, on the areas and branches which constitute the actual or obviously foreseeable sources or destination, for the most sizable economic transactions between those countries. It is these weighty polarizing flows that will possibly lend the main thrust for the justification and consolidation of the Block. However, this does not mean that the effects of the integration cannot come to be important, as well, for other areas and segments, of lesser dimension and visibility in this global scenery.

Within this context of a prospective consolidation of a wider regional block having the Mercosur as a starting point, our concept of peripheral areas encompasses both countries of lesser economic dimensions and less developed areas of the larger countries, provided that they do not constitute neither the most important sources nor destination of the current, or foreseen, flows of economic transactions among the countries of the Block.

A first reference to this line of argument appeared in Sicsú and Katz, 2000, whereby we argued that, besides the more obvious, and often referred to, potential advantages accruing the most dynamic poles of the economies of Mercosur, even an area as the Brazilian Northeast could benefit from its consolidation[3]. Of course, one does not think that insertions of this kind can become generalized, or that their aggregate impact will come to have a dominant weight in the process. Most certainly, they will rather concentrate on specific segments and in localized productive chains, although they can be very important for those involved with them.

As mentioned earlier, in a more recent work, Katz et all, 2002, we had the opportunity to verify that countries of smaller dimensions, and therefore peripheral in terms of the ensemble, did not get large gains from the integration and, in some aspects, may even have incurred in losses, as a result of the process. In discussions with colleagues of the Department of Economics of the Catholic University of Uruguay, we concluded that Uruguay is an example of such kind of outcome. But, at the same time, we agreed that this result is not a necessary, nor the only possible one. From this understanding there arose a commitment to engage in a joint effort, aiming at further and deeper exploring these issues.

The central idea of the research we are now carrying on, in relation to Brazilian Northeast, Uruguay and, possibly, other peripheral areas - in the sense we are using the concept of "peripheral", i.e., as related with the integration of Mercosur - is that the latter creates a new scenery of microeconomic reality, that can offer new and varied business opportunities. That is so for many reasons, an important one being the lowering of tariffs and the elimination of other barriers in intra-block trade. As stated in the title of this text, new opportunities, and vulnerabilities, will possibly arise, regarding peripheral relationships in Mercosur, which are prone to alter the functioning of productive chains in these areas. A study of these possibilities can allow for a timely identification of some problematical points and the elaboration of propositions for facing them. Also, it can indicate areas that should be explored, either by the private or public sectors, with a view to maximizing the gains of the process. And, even more interestingly, it seems to us that opportunities can be spotted for new connections with mutual gains, between peripheral areas. The identification of one or two of such potential trouble points, or of such opportunities, would undoubtedly justify the study. In any case, it is important to ponder whether such insertions are sustainable or if they are excessively vulnerable to abrupt changes of the situation. It is also fundamental to detect who, or what, defines the strategy of the productive segment and the amount of bargain power one has in the process.

With the objective of clarifying the main idea subjacent to this work, let us refer to a fact that conforms to the type of situation we have in mind, and actually will be one of the concrete cases contemplated in our study. This is the case of the poultry farming industry in Brazil's northeastern state of Pernambuco. As it is known, this sector had a good and steady growth in recent period, and has already reached an important position in our economy. However, more recently, it has plunged in a deep crisis that began to revert to its trend performance, jeopardizing its ranking as an important economic activity. In fact, there is news that many plants are being transferred to other states. One of the central problems lies in the supply of feeding grains, an essential input for the activity. The difficulties derive both from the irregular availability of cereals and from their prices and freight fees. It happens that the provision of cereal for the poultry farming industry of Pernambuco does not originate from local agriculture's production and depends, to a great extent, on production from distant regions. Now, in the context of the integration of Mercosur, when the barriers and tariffs on grain imports would stop being an impediment, it is positively conceivable a scenery whereby conditions might be created for a coastal sea freight flow, which carry products from our area to Uruguay or Argentina, and bring grains for the poultry industry of Pernambuco and of northeastern Brazil. Of course the feasibility of such scenery must pass the test of, among others, costs, markets dimensions and demands microeconomic analysis. Nevertheless, considering the importance of all the elements involved in this question, it no doubt deserves the toil of the exercise.

At last, one aspect that should be stressed again is the need to institute supranational structures, so as to confer stability and equilibrium to the operation of the Block. Such institutions have been created in blocks that are not unipolar, and one of the ways they operate is promoting lateral compensations to countries, and areas of countries, which would be otherwise losers. Of course, support and incentive to opportunities and connections among peripheral areas would be, par excellence, the ideal ground for this type of action.

III. The on-going research

Our main methodological objective is systemizing an approach for the analysis of changes in the microeconomic framework, due to a process of multinational regional integration. This approach will be used to analyze the conditions of insertion of two peripheral areas of Mercosur, Brazil's state of Pernambuco and Uruguay. Concretely, we will try to detect opportunities and vulnerabilities that might come about thereby. The analysis will unfold in the stages described below:

- ?? Detection of the main productive chains, with relevant operations in these economies;
- ?? Detection of those chain's logic of operation and of the factors that condition their evolution;
- ?? Identification of the exports and imports flows between these economies over the last years;
- ?? Comparison of data from the tables of inputs of several productive chains of Pernambuco and of Uruguay, with a view to detecting new feasible interactions and, thus, selecting which of the chains to focus in the study;
- ?? Analysis, from a microeconomics point of view, of the concrete possibilities of occurrence of interactions, and the opportunities and vulnerabilities that might emerge thereby, for the most important cases;
- ?? Analysis of the role public policies could or should play, in order to support the consolidation and competitiveness of those segments;

Modeling of a framework of foreseeable features of the social and economic impacts resulting from the integration as well as their likely reflections in terms of changes in the conditions of life of the populations of those areas. To accomplish the work, we are performing the following research stages:

a) Survey and analysis of bibliographical material of reference in the fields of international trade, regional and global productive chains, formation of economic blocks and socio-economic impacts of new productive arrangements;

b) Starting from an analysis of the imports and exports register of the areas under study, and of the inputs of the productive chains, detection of the more relevant productive chains for the integration;

c) For some of those chains, the ones we consider to have more vulnerability and or offer positive opportunities, delve the investigation down to four levels, which are:

I. Detection of the logic of production and of integration, characterizing the agents with strategic decision power.
II. Characterization of the productive chain 'governance' and of its enabling institutional arrangements.
III. Characterization of the productive flows and commercialization channels, attempting to underscore main partners and insertion in the global and or regional productive chains.
IV. Characterization of the dynamics of innovation and of the actors that define the technological paths of the sector.

By this way, and once put together such frame for the cases presenting real possibilities for the interaction to emerge, we will try to define and to characterize those chains' relevance for the economies under consideration, with respect to both income generation and employment opportunities. At this stage, we will organize all these pieces of information and prospective views and promote workshops, in Pernambuco and in Uruguay, in order to discuss them with relevant representatives of the public and private sectors. In these seminars we will submit the findings to the screening of business' and workers unions' leaders of the industries concerned, experts from the academy and relevant public institutions staff. Hopefully, such discussions will come up with pertinent conclusions, concerning insertion strategies able to attract the private sector, and or providing guidelines to public policies of intervention.

Finally, we will promote a conclusive conference in Recife, Pernambuco, when a comparative analysis of the Uruguayan and northeastern Brazil cases should allow us to summarize and systematize the most important aspects that can influence the tendencies of those economies.

References

Contact the author for a list of references.

End Notes

[1] The title of the book is "Mercosul: Mudanças Necessárias", referred as Katz et al, 2002. The authors are the same as the ones of this paper, plus the economists Keila Sonalle and Romina Paradizo.

[2] The last important conflict in Mercosur hinged around exchange rates. But, in any other occasion, confrontation may arise from many other different sources. The idea we advocate here is a general approach towards striving at anticipating and bypassing conflicts, rather than a possible treatment for a specific problem, no matter how important it may be. But quite independently of all these reasons, the supranational structures are indispensable because, to guarantee the cohesion of the block, it is necessary to assure that all the countries, even the less powerful ones, also benefit from the integration, and it will only be possible to have this for sure through the establishment of the "lateral payments".

[3] Mercosur has been operating, with highs and lows, since 1991, and now confronts a phase characterized by uncertainty. As we refer to its consolidation, we have in mind the moment when all doubts about its continuity are dispelled and its operation's characteristics are strengthened.

The Role of Asia in the New World Economic Order: New Opportunities and New Challenges for World Markets

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Abstract

Western economists observe with a quite particular interest the very inequal, —sometimes very fast— and the new orientation of the economic evolution of Asian countries since the beginning of the reforms of the 80s. Since then, these countries present the industrial and commercial world a major interest for investors of the rest of the world. The focus of this paper is not to explicate Asian economic growth to regional experts but rather to take stock of key issues that are of concern to outside observers such as academic economists in regions such as in Europe.

In this paper, we note the importance of risk in the economic transitions now taking place in China and in other East Asian economies. How East Asian economies choose to manage this risk is of central importance not just to academic economists but also to prospective investors and trading partners. With China as a case study focal point, we note that China's accession to membership in the WTO has momentous consequences for its participation in the global economy, and more particularly how it chooses the transition to a more privatized and free-market economy. Some countries, including Vietnam, Cambodia, and Laos, have yet to embrace the full panoply of free-market institutions, and face the additional risk of slower growth than in a more reforming economy such as China.

In looking at the Chinese experience, we note that even with its emphasis on market-based reforms, it may not be able to sustain the rates of economic growth that it has enjoyed since the earlier years. Measurement problems make it difficult to track these issues, but we conclude that China may well provide a new model for economic growth from which East Asian and other newly emerging economies may learn.

Introduction

Western economists have noted with particular interest the rapid evolution of the Chinese economy following the reforms begun by Deng Shiao Ping in the late 1970s. Since then, China has become a commercial and industrial world power, and has begun to assert its weight in international affairs. The focus of this paper is not to provide an analysis of Chinese economic growth through a repetition of processes that are already relatively well-known. Instead, I plan to concentrate on how European economists interpret this extremely rapid economic transformation, and to spell out what Europeans expect from this process as economic and commercial partners.

The important reforms undertaken by the Chinese administration have been adopted within the framework of a market socialist economic model. As such, China has moved to open its markets to international investment while expanding its trade with other parts of the world, while at the same time preserving the political dominance of the Chinese Communist Party. While China has not yet embraced the kinds of democratic political institutions that many other developed countries take for granted, it has been able to pursue rapid economic growth through market-based liberalization.

Chinese economic agents, especially the young emerging business leaders, have figured out how to adapt quickly to the new flexibility and growth of their economy. They have been able to respond quickly to incentives and to the possibilities offered by the new international economic framework in which they are participating.

For more than a year now, China has been a full member of the World Trade Organization. In so doing, it has embraced a path of modernization of activities and the adaptation of institutions to the rules of international trade. As a result, China is positioning itself to compete on a global level and is preparing itself to respond to the challenges of modernization and competition. Indeed, no one doubts the entry of China on the global stage.

In observing China's economic transformation, western economists have asked three types of questions:

1. In terms of domestic economic performance, has China found a way to avoid the traditional business cycle?
2. With its 1.3 billion consumers and its membership in the WTO, has China become one of the most important economies in the world?
3. Finally, on a scientific level, are currently available statistics sufficiently valid to track and predict the continuing evolution of the Chinese economy?

1. Thoughts on the Sustainability of Chinese Economic Growth

1.1 Fluctuations and Mastery of China's Economic Growth

Most economists would agree that the kind of robust economic growth that one observes in China cannot endure indefinitely. With rates exceeding 7.5 percent (9.4 percent in 1999, 7.9 percent in 2001), over a period of twenty years, such growth makes one think of overcoming more developed economics but at the same time, raising the question of secondary effects with which the Chinese will have to contend or master. These effects arise especially at the social and cultural levels.

Social and cultural pressures are increasing as China's relatively high rates of growth take place unevenly across sectors and geographic regions. Coastal areas, and those favored by special economic legislation, are experiencing the most rapid economic growth, while communities farther in the interior are growing much less rapidly. As this takes place, productivity norms and competitive standards in a global economic environment generates rising unemployment in less advanced areas, especially among the less well educated members of the labor force. This is further exacerbated by the shift to privatization of industry, hitherto a source of guaranteed employment in a once closed economic environment.

1.2 Adaptability of the Administrative and Institutional Framework

The institutional framework of China remains very removed from the traditional framework of market economies in other parts of the world. We note in particular several distinctive features.

1. China's markets have experienced a progressive but thus far only partial economic liberalization;
2. Functional boundaries of responsibilities between the public and private sectors remain largely porous and weakly defined;
3. China's once centralized planning system has evolved in a quasi-independent fashion in relation to free market reforms that are coming to dominate the economy;
4. Privatization of enterprises has thus far been relatively limited;
5. Economic reforms are producing a transfer of government responsibilities to local government institutions as well as to private markets, and local government institutions are acquiring these functions based largely on geographic proximity independently of any rigorous economic criteria;
6. As a general rule, economic reforms in China are increasing the efficiency of the allocation of resources as well as an increase in the productivity of firms.

Despite these changes, the reform of public enterprises has resulted in a substantial contraction in public sector employment and a corresponding increase in unemployment. Informal estimates suggest that the number of unemployed may be as high as 17 million. In addition, economic growth in China is tied to the rapid development of the industrial sector, and as a result, drives and anticipates the modernization of the agricultural and rural sectors of the economy. In response, Chinese authorities have focused on the development of township and village enterprise initiatives to assist in the process of economic reform. The purpose of this initiative is to slow the degree of urbanization of relatively unemployed members of the labor force who most likely would not be able to compete in the international economic environment. In turn, local authorities have looked to state-funded support to ease the fiscal burden of local level enterprise initiatives.

1.3 Regionalization is a Necessary Pre-Condition for Successful Globalization

As noted above, China's economic growth is unfolding in a geographically uneven fashion. Successful strategies thus most focus on the development or geographic regions. Geographic regions provide an information framework for major economic decisions as well as for potential foreign investors. They do so in terms of participation in the development of local institutions. This includes cantons, municipalities, and individual provinces as the location of productive sites for employment, and thus in terms of local purchasing power.

The Central Region of China is the one targeted to provide a bridge between the dynamic coastal regions and the interior during the next ten years. It is expected that the Central Region will help to avoid bottlenecks in production, investment, and employment. It is very spread out and encompasses a population roughly equal to the Coastal Regions.

The principal objective of this initiative is that it will lead to a diffusion of economic wealth. Redirected economic investment will help channel wealth from the coastal zone toward the interior through both direct and induced effects. However, only through the detailed feasibility studies that are thus far difficult to undertake can one determine if this strategy will lead to the successful outcomes that Chinese officials hope will occur.

Any redirection of investment and production toward Central China will depend on several considerations. They include:

1. If it is undertaken in an economic zone that already has a suitable infrastructure, such as the Yangtze river basin;
2. If it is undertaken by firms that are sufficiently well established and capable of absorbing the likelihood of unanticipated financial loss over an extended time horizon.

The accelerated transformation of China leaves little time to develop a more balanced framework of internal economic and social relations that link hitherto isolated communities to the national and international level. Secondly, China will have to pursue a rational development of resources and advantages that will provide dynamic growth in the provinces with those of the coastal regions. In so doing, rural communities will be forced to embrace commercial, economic, political and social norms that are already required by an interdependent global economy.

2. China's Growing Role in International Markets

China's admission to the World Trade Organization brings new concerns to Chinese nationals and to their economic partners. We list below some of these key factors.

2.1 Implications for the Chinese

Access to international markets and the adherence to established international rules will undoubtedly create new hierarchies and a re-orientation of economic activity in China. Some of these changes will have more promising effects if they are directed toward international markets. Out of this process, a veritable "adaptability rent" will be born by the speed with which a Chinese firm can respond efficiently to the demands of international markets.

If China's provinces constitute a new economic network linking them to the global economy, this will undoubtedly weaken some of the inter-regional links that used to tie various rural regions with each others. As a result, some rural provinces will acquire competitively dominant positions in contrast with the cooperative relations that used to prevail. The eventual unlinking of inter-regional rural ties, while promoting a deepening of vertical links to the global economy, may work poorly in those regions where investments are poorly coordinated and in which highly uneven economic growth takes place.

a. Implications of China's New Role for its International Economic Partners

China's new participation in the global economy will produce differential effects not just on markets but also on its trading partners. Since we are talking about globalization, these partners include:

1. Rich countries and newly industrializing countries;
2. Relatively undeveloped countries and other emerging economies.

In turn, different countries will find that the distribution of world income will depend on part how each adapts new policies in response to the growth in global economic interdependence.

b. Implications for Rich and Newly Industrializing Countries

International firms from industrial economies and newly industrializing economies have generally tended to redirect part of most of their production from existing industrial markets to emerging markets such as in China. Some, such as Japan, experienced considerable difficulties in this process, such as what took place during the 1990s. In the Japanese case, social costs increased rapidly, a strong currency reduced export growth, unequally competitive salaries in relation to their Asian trading partners, and high consumer prices all contributed to economic stagnation, rising unemployment, and business failures.

Western firms, as well as Japanese firms, when faced with non-competitive domestic conditions, often chose to relocate operations in a more favorable environment such as China. They were able to take advantage of relatively low labor costs in comparison to their Asian trading partners, to enter new local markets, and to establish valuable networks for prospective new markets and consumers.

In terms of prospective markets, consider some basic comparisons. First, as of March 2002, there were 162 million cell phones in China and 5 million automobiles for which demand has been expanding by 1 million each year. At the same time, western firms have developed new marketing strategies in order to adapt to more complex local conditions, conditions often misunderstood by Western firms but now viewed much more carefully. In turn, production by rich countries and by newly industrializing countries have focused on the choice of goods that integration their production with a high value added, often intermediate goods. In 2001, such goods accounted for more than fifty percent of exports and roughly equal to China's total imports.

For Western and neighboring Asian countries such as Japan, Thailand, South Korea, Singapore and Malaysia, the entry of China into global markets is a natural complement to many of the products that these same countries are also in the process of producing, though sometimes at different stages of transformation. Rich and newly industrializing economies thus generally benefit from China's opening of its markets to their products.

China's entry into the World Trade Organization provides global markets with a framework that is sufficiently flexible for the expansion of global trade and production. The establishment of free trade zones in which there is a subtle and disciplined coordination of trading partners helps avoid a fallback to older protectionist measures in which competing countries would engage in beggar-thy-neighbor tariff and quota restrictive policies.

As harmonious as this may seem, one fallback that should be noted is that if Chinese firms engage in producing exports that contain high value added, this may spell trouble for the kind of partnership relations that have characterized international trade and investment thus far. Nevertheless, in the present environment, there is a productive and positive atmosphere in which Western firms seeking to do business in China may learn more about local customs and traditions.

c. Implications for Other Emerging Economies

Unfortunately, for many emerging and developing economies, their activities are much less complementary to China in that they are engaged in efforts to replicate too many similar types of low value added goods. We note in particular that for many member countries in ASEAN, as well as for India, Sri Lanka, Bangladesh and Pakistan, the effects of China's entry into global markets may not be as beneficial. These countries possess similar advantages relative to Western developed economies: firms engaged in traditional textile production, high hourly costs of production (40 to 50 cents per hour of labor), and thus lower than in China (62 cents per hour). This suggests that the real competition in textiles and clothing will be among Chinese and East Asian producers. This is particularly so for countries such as Thailand, Malaysia, Indonesia, and Vietnam, not to mention, Laos and Cambodia. Outside of Thailand and Malaysia, these countries are relatively poor and their prospects are dimmed rather than advanced by the entry of China on the global economic stage.

3. Measuring Economic Fluctuations and Their Effects

Quite naturally, economists are interested in measuring fluctuations and their effects on the balance of economic power that is taking place in Asia. We note some key dimensions of this change as well as the implications they represent for economic relations between China and her Asian neighbors as well as between China and her trading partners in other parts of the world.

3.1 Domestic Economic Fluctuations

Tracking China's economic performance is a daunting task for both Chinese and outside analysts. The main reason for this situation is the lack of dependable statistical gathering and validation institutions, many of which rarely, if at all, take into consideration China's large informal sector. As a result, estimates of China's global economic growth rate, as well as wages and salaries, should be treated with considerable caution in any formal economic analysis. In our view, despite the difficulties in deriving more precise statistical estimates, in general it seems clear that China's opening to the rest of the world has placed it in a position of incontestable leadership in East Asia. Its influence in the global economy will be felt with increasing weight over time.

3.2 China in the International Arena

Turning to China's international performance, we note some cautionary concerns. Central to this concern is once again the question of measurement, in particular:

1. The external re-orientation of Chinese markets, and thus the growth of exports and imports of China;
2. Induced effects brought about by China's admission to the World Trade Organization.

This said, it is increasingly clear that China is becoming the dominant economic power in East Asia. How rapidly and to what extent this will take place depends in part on improvements in the quality of statistical data, which we view as essential to a better understanding of this process.

4. Theoretical and Policy Considerations Relevant to China's New Economic Policies

The theoretical framework of international economic integration can be traced back as far as the 18th century. At the time, countries on the eve of the industrial revolution in Western Europe faced the challenge of whether increased dependence on international trade would abet or hinder the process of economic growth. As debate unfolded and experience in the industrial revolution and economic growth expanded, economists extended the earlier discussions to take into account new insights that are pertinent to the context of China's new economic policies today.

Let us note how the theory of international trade has evolved. We cite the following theoretical contributions:

1. Comparative advantage (Ricardo)
2. Trade creation and trade diversion (Viner)
3. The law of factor proportions (Heckscher, Ohlin, Samuelson)
4. The gravity model of international trade (Tinbergen, Linnemann)
5. The "wild flight" or random effects model of trade (Akamatsu)
6. Intersectoral Linkages in international trade (Helpman, Krugman)
7. Factor endowments and gravity factors (Bergstrand)
8. Frontier effects (McCallum, Head, Mayer, Poncet)

This list is not meant to be exhaustive, nor is it our intent to test any particular version as it applies to China's new economic growth. We note again that any effort to develop empirical estimates for the Chinese economy is limited by the incomplete and inadequate statistical sources that we have already noted. Rather than attempt such a modeling exercise, then, we propose an institutional model that takes into account cultural and behavioral characteristics that in our view are essential to understanding China's economic success.

4.1 A New Approach to Understanding China's Economic Growth

In our view, there are seven key dimensions to China's economic success. We note the following:

1. **Causes of Economic Fluctuations**. The standard framework is in a constant state of flux as China's dependence on globalization expands. It is important to analyze non-synchronous patterns of China's economic fluctuations. We consider that part of this behavior is to be found in natural elements within the Chinese economy, by which we mean demography and natural resources among others. In addition, we also point to the role of cultural forces in shaping Chinese responses to economic growth. In particular, we consider the religion, ideology, established habits, and traditions can explain part of the responses we find within Chinese society as new economic growth and fluctuations occur. We add to this the importance of material elements such as living standards and the economic and financial infrastructure as key factors that can explain major fluctuations in China's economic growth.
2. **The predominance of dis-equilibrium states**. China, as many other countries have experienced, does not enjoy economic growth along a neat mathematical continuum. In

fact, dis-equilibrium is more typically the norm. This is due not just to inadequate statistical estimates, but to the basic process of globalization in the economy.

3. **Emergency Strategies**. China is perforce required at the present time to adopt short-term strategies for globalization. Moreover, it also must do so step by step and region by region, often building institutional links between governmental institutions and small and medium-size firms.
4. **The Necessity of Pragmatic Policies**. China can not face globalization with a closed-mind set that reflects historical ideology. The current leadership recognizes full well that its legitimacy derives in no small part from improving living conditions among the vast majority of the population.
5. **An Understanding and Willingness to Take on Risk**. Any type of major economic reform poses inherent risks. Such risks are at the same time economic, political and social. Again, China's leadership recognizes that there are inherent risks in globalization and is determined to find ways of anticipating them, devising suitable responsive strategies, and implementing them in ways that avoid a larger upheaval.
6. **Shifts in the Balance of Power**. China's leadership recognizes full well that economies that fail to adopt a positive approach to globalization are likely to fall behind in the effort to improve living standards and to achieve a position of influence in the global economic community. As can be noted in the declarations from Beijing, there is a full recognition that at present the weight of global economic policies still lies with richer and well organized economies and that in order to participate in such policies, China will have to increase its economic weight through sustained economic growth.
7. **Integrating Actions**. As we move into the 21st century, it is clear that no country can prosper independently of others- we are all globally interdependent. Reorganization of the economy is a response to globalization. This requires a reorganization of the balance of power within the economy, as well as a modernization of the infrastructure and capital stocks. The process of internationalization, of globalization, represents powerful forces that will bring the world much closer together than ever before.

Conclusion

Countries such as China are experiencing systematic rapid evolution in which their economies are being transformed in a relatively short time. This places pressure on their social structures, on existing traditions, on the balance of relationships between urban and rural populations, on the relations between agriculture and industry, and on the relationships between the formal and informal sectors. This is especially true in China which has developed an original model for modernization, growth, and development, and which is increasingly atypical of a socialist market economy. China's experience will undoubtedly transform the structure of both economic theory and policy, not just in terms of the choice of an economic system, but in terms of a model for our times.

Appendix

TABLE 1: PRINCIPAL ECONOMIC INDICATORS

Country	Pop. 1988 million	Pop. 2001 million	2001 / 1988 ratio
China (+HKG)	1085 .1	1269	1,17
India	781 .4	1016	1,30
USA	243 .8	282	1,16
Indonesia	170 .6	211	1,24
Brazil	141 .5	171	1,21
Russia	132 .2	146	1,10
Pakistan	102 .2	138	1,35
Bangladesh	102 .6	131	1,28
Japan	122 .1	127	1,04
Nigeria	102 .0	127	1,25

Country	GDP 1988 bill$	GDP 2001 bill$	2001 / 1988 Ratio
USA	4488	7182	2,13
Japan	1923 .7	3954	2,34
Germany	881 ,8	2067	2,38
France	715 .5	1453	2,00
Gt.Britain	586 .7	1447	2,49
Italy	604 .1	1186	1,95
China (+HKG)	353 .8	1315	3,56
Canada	402 .4	650	1,55
Brazil	287 .3	482	2,78
Spain	233 .1	616	2,49

Of the Top 10 Countries:	million 2 984 (%) 57	million 3 618 (%) 59	x1 ,21
6 are Asian	2 364 45% of world	2 900 48% of world	x1 ,22
APEC -AM		1 800	
World	5 200	6 060	x1 ,17

Of the Top 10 Countries:	Bill. $ 10 476 75% of world	Bill. $ 23 500 80% of world	x 2,24
2 are Asian	2 277 16% of world	6300 23% of world	x2 ,49
APEC -AM		7 000	
World Total	14 000	30 000	2,14
Per Capita	2700	4 950	x1 ,83

Sources:

1. *Etat du Monde 2003, (Ed. La Découverte, oct. 2002)*
2. *Atlaseco 2003, (Nouvel Observateur, Oct. 2002)*
2 *Direction des Etudes Economiques et Financières du Crédit Lyonnais, avril 2000*
3 *Banque Mondiale, http:/www.worldbank.org/ et FMI, http://www.imf.org /*
4 *Asiaweek, http://www.asiaweek.com*
5 *China Daily, http://www.chinadaily.net/*
6 *WTO, http://www.wto.org*
8. *http://www.chinavista.com*

TABLE 2: PRINCIPAL ECONOMIC AGGREGATES OF CHINA

	unit	1996	1997	1998	1999	2000 (p)
GDP	Bill. $	834	917	965	1007	1098
Growth Rate	%	9.6	8.8	7.8	7.1	7
Per Capita GDP	$	682	742	794	800	830
Inflation Rate	%	6.1	0.7	-2.5	-2.9	-1.5
Foreign Debt	bill $	150.3	166.5	172.7	164.1	163.6

	unit	1996	1997	1998	1999	2000 (p)
Goods Exports	bill $	151.0	182.7	183.5	194.5	206.0
Goods Imports	bill $	131.5	136.5	136.9	165.0	175.0
Goods Balance	bill $	19.5	46.2	46.6	29.5	31.0
Exports Services	bill $	20.6	24.7	24.1	26.0	27.0
Imports Services	bill $	34.1	45.6	46.3	50.0	51.0
Exports goods & services	bill $	171.6	207.4	207.6	220.5	233.0
Imports goods & services	bill $	165.6	182.1	183.2	215.0	226.0
Balance Goods & Services	bill $	6.0	25.3	24.4	5.5	7.0
Transfers	bill $	2.1	5.1	4.3	3.7	4.0
Transfers Balance	bill $	-0.8	-0.8	0.5	-0.3	-0.5
Current Acct. Balance	bill $	7.3	29.6	29.2	8.9	10.5
Reserves	bill $	107.0	142.7	149.2	159.0	170.0
	Months' Imports	9.8	12.5	13.1	8.1	11.4

TABLE 3: PROFILE OF THE CHINESE BANKING SYSTEM

(as of December 31, 1998)

Type	Asset Share
State Banks	62.3
Cooperatives	12.4
Other Commercial Banks	11.0
Development Banks	9.0
Trusts and Investment Banks	3.5
Foreign Banks	1.8
Total	**100.0**

TABLE 4: COMPOSITION OF CHINA'S INTERNATIONAL TRADE

(in $U.S. billions, 1998)

Exports	Amount	Percent
Textiles, Clothing, Shoes	50.80	27.70
Machinery & Transport Eq.	50.22	27.30
Chemical Products	9.60	5.20
Mining and Energy	5.20	2.80
Agribusiness	4.30	2.30
Other	63.50	34.70
Imports	**Amount**	**Percent**
Machinery & Transport Eq.	56.8	40.5
Chemical Products	20.2	14.4
Textiles, Clothing, Shoes	1.11	7.9
Mining and Energy	6.8	4.8
Iron and Steel Products	6.5	4.6
Other	38.9	27.8

Source: People's Bank of China Annual Report (PBOC)

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Regional Innovation Systems in Mexico and Canada: A Comparative View

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Abstract

Innovation systems arise when firms realize that, in order to compete and innovate, they need knowledge that is beyond the capacity of any individual organization to generate or assimilate. As they begin to collaborate, they need specific social capital on which to draw, in order to complement their resources in a competitive fashion.

The economies of British Columbia and Mexico are in transition, from being resource-based, into industrial and service ones. However, they draw on different resource pools and social capital. How do these two countries' social capital compare? Which are their relative strengths and weaknesses in this area?

This paper presents results from research conducted in innovation networks in British Columbia and Mexico. Fieldwork includes interviews with members of organizations that actively participate in those networks. Underlying institutional principles governing their development in both countries are identified. Policy implications are derived, with particular emphasis on the Mexican case.

The Name of the Game: National and Regional Innovation Systems

As the concept of the knowledge society has become commonplace, research on how the relevant social structures and processes support economic competitiveness has increasingly gained in importance. Specialized research has gone on to develop an understanding of the role that national and regional systems of innovation play in economic competitiveness. Identifiable components of those systems, such as universities, major R&D labs, skilled labour markets, venture capital and science parks, for example, are closely scrutinized, in order to assess their role in those systems, and to identify ways in which to enhance their performance [see Salter and Martin 2001, McKelvey et al. 2003, de la Mothe 1994, for example]. The World Bank and OECD [OECD 1997, 1999] have explicitly endorsed the national and regional systems of innovation approach to the development of policy measures in industrialising countries.

This approach has been relatively uncontroversial in countries with an advanced industrial context. However, its relevancy to developing economies like Mexico is not as clear yet. It is usually understood that countries like Mexico should not attempt to blindly follow or copy policy measures that have been successful elsewhere. But there is always the need to spell out the reasons for which some measures have been successful in a given context, so as to provide a firmer basis on which to devise policy measures in less-developed countries. Can those reasons be identified in field research in a useful way? Can *a posteriori* explanations of successful development of given innovation systems provide a sound understanding of what is needed to *create and develop* new innovation systems, where only some of the ingredients seem to be present?

In many countries, a strong interest in the relative effectiveness of federal and regional relevant policy measures has ensued. Whilst some countries (like the Netherlands) are small enough so that their innovation systems can be strengthened through national level policies, others (like Italy, for example) have their regional systems of innovation (RSI's) highly differentiated at the regional level. This concern is usually related to that of the relative influence that external (exogenous) efforts, resources and policy measures may have in the development and viability of a certain RSI. Frequently, these influences are distinguished from endogenous factors, such as a certain level of economic and technological activity, or the presence and nature of social capital, for example, that arise out of processes that are not centrally (at a federal level) or locally managed. In the specialized literature this issue is also generally associated with that of the relative efficacy of policy measures, as opposed to more spontaneous economic and social processes.

Canada and Mexico, as signers of NAFTA, are also involved in a common set of economic ties, in a system driven by the US economy. NAFTA calls for complementary roles (like those of resource and labour providers, for example), but also for similar competitive capabilities. Both countries share a significant need for the development of endogenous technological and innovation capabilities.

Canada and Mexico share a common characteristic: they are large federal countries, in which economic activity and industrial clusters may in varying degrees be responsive to policy measures at both the federal and the regional level.

Canada's current drive for innovation-based competitiveness is a very strong effort to close the "competitive gap" with the US. Among the Canadian provinces, British Columbia shows strong parallels with the Mexican context, which makes it an interesting and relevant case for understanding the development processes of RSI's. Such understanding may have important implications for the design of policy measures in Mexico.

The Process of Development of a Regional System of Innovation

A significant proportion of the specialized literature [Longhi 1998] argues for the existence of a set of preconditions for the development of a regional system of innovation. These preconditions include: a) a coherent set of territorial relationships among all economic actors, b) a specific culture, and c) a shared representation system, implying a strong consensus and integration among them.

A second level of preconditions emphasized in the literature is the existence of a local technology resource base, or knowledge base. This may be a large firm, a research institute or a university, that gives rise to the development of distinct core competencies in the region. This resource base spreads locally and in strong interaction with other actors through the process of spin-off formation and integration in strongly interacting networks. These elements are frequently reported in the literature as being complemented by later arrival of firms and organizations that reinforce the networking interactions and learning processes among all actors.

According to some authors, these enabling factors need not be present simultaneously, nor is there necessarily a specific sequence for their development. Judging by the accounts presented in the specialized literature, there are many different pathways through which a RSI can grow.

A different approach is held by other authors, who hold that a set of key factors, should foster the growth of a high technology district. Among the factors commonly identified as providing the appropriate conditions are:

?? "A leading scientific university and associated research complex
?? A prestigious industrial or science park
?? A desirable social environment to attract and retain high calibre personnel
?? Provision of venture capital
?? Public support for innovative technology
?? A facilitating labour market providing requisite skills". [Garnsey 1998, p 361]

Still, there is the problem of explaining "How and why some places develop expanding industrial complexes while others move along other trajectories or even remain stillborn". (p 361).

Other approaches emphasize that it is not the set of factors or facilitating conditions that gives rise to a RSI, but rather the sequence of cumulative interactions between them and feedback effects, where cumulative causes are at work and each sequence of outcomes is shaped in part by prior events.

Even though detailed specification and rigorous empirical identification of conditions characterizing successful high-technology milieux would not provide easily generalizable results, the examination of a specific system may help understand common processes that nevertheless produce distinctive trajectories.

Research Questions

Which are the most salient characteristics of the British Columbian and the Mexican context, those that best illustrate the relevant systemic processes in the development of their RSI's?

What are the institutional arrangements that explain the relative differences in the development of their RSI's, in the view of their most relevant actors? Which are the roles assumed by local network actors? How do they learn to play those roles, and to articulate them in a complementary fashion?

The literature on RSI's resorts frequently to the notion of "path-dependency", in order to explain, *a posteriori*, the relative success, of innovation clusters. In this case it might therefore be useful to explore whether the effectiveness of policy measures was determined by specific variables in the previous development of the corresponding RSI's. Is current progress in their development due mostly to policy measures, or to endogenous processes that may have been acting earlier?

Moreover, as in many contexts, field research in the Mexican case has shown that it is easy to identify many pieces of the system that are in place. However, stable networks have so far failed to develop consistently. Interaction among actors in the system is not occurring as expected. Why is this so?

As discussed by Niosi and Bas [Niosi and Bas 2001] show, the problem is not whether a given region has a specific set of resources or not, but HOW it assembles those resources into specific *competencies*. How do the right interaction patterns develop? So far, the specialized literature has discussed the presence of social capital, in the form of a common language or representation system [Longhi 1998] that permits learning, as well a trust and honesty, that enable the shared and complementary search for knowledge and innovation [Camagni 1991]. But how do are those elements of social capital developed? In which ways do they enable the right kinds of interaction?

A RSI is a system of interdependent actors. However, there is no central coordination mechanism. An alternative is to view the system as a self-organizing system, as a *complex system*. In it, each actor makes decisions that guide his actions according only to his own interests, and to locally available information. What is it that gives coherence and directionality to the whole system?

In what follows, we present results from two parallel research projects. One of them was done in Vancouver, British Columbia, in Canada. It dealt specifically with the composition and the processes that give coherence to its biotechnology innovation cluster. The second research project deals with the emergence of innovation networks around public research centers in Mexico. From the comparison of these two cases, policy implications are discussed.

Methodology

In both cases the studies have been built through semi-structured interviews. In Mexico, interviewees included relevant actors in innovation networks in Central Mexico:

- R&D personnel in public R&D laboratories, whose mission is to develop technology and transfer it to
- industry.
- Former and current public R&D laboratory managers;
- Representatives from firms that have hired the labs' services or that have contracted technology
- development and transfer projects with them.
- Business trade associations' leaders.
- In British Columbia, the study focused around the development of the biotechnology innovation cluster.

Interviews were held with:

- Government officials in agencies responsible for the enhancement of business environment;
- Trade associations' leaders;
- Leaders of NGO's dedicated to the promotion of high-technology industry;
- Dedicated biotechnology firms' CEOs;
- University – Industry Liaison (technology transfer) Officers;
- University research officials;
- Science and Technology policy analysts;
- University researchers in high technology areas.

Content analysis of interview transcripts was conducted with QSR5 – NUD*IST software, in order to identify, code, and group relevant response categories. The focus of the analysis was to identify *patterns* in responses to questions.

The British Columbian Case

Mostly for geographical reasons, British Columbia can be thought of as an economy that in many aspects is similar to that of Mexico:

a) It is a transition economy. From being a resource-based, BC is moving towards a service-based economy, without going through a major manufacturing phase, by attempting to use its competitive advantages of scenery and climate to promote tourism, film production and high-tech industries (industries where lifestyle is a major factor in attracting highly skilled employees).

b) As part of this effort, BC's organizations display very explicit efforts to rely on innovation, rather than on natural resources, as a strong economic driver.

c) It is being successful identifying and promoting the development of specific and competitive RSI's.

In BC, as in the rest of Canada, technology development initiatives have been in effect for decades. Mission-oriented[i] views of science and technology have oriented initiatives that fuel technology and innovation, and guide them towards well-defined social and economic goals. As reported by interviewees in the study, these views were developed in a vein similar to that of the US and European countries, where scientists played an important part in the war [Bush 1945].

Thus, initiatives in the country are a way to harness the power of S&T to satisfy major social needs in areas like biotechnology, environment, and so on. Initiatives are designed and developed on the basis of continuing consultation processes in which the scientific researcher community, research institutions, business leaders, and ONG's, for example, participate. Initiatives at the federal level are frequently mirrored at the provinces' level.

A national review S&T was conducted in 1994. Among the goals stated in a guiding document released prior to the review, the government's goals in the process were:

1. "To keep interested Canadians informed about the review exercise and the development of a new federal science and technology strategy."
2. "To provide opportunities for focused debate among Canadians on federal policy options for science and technology."
3. "To listen to the ideas and suggestions of interested Canadians which can be used to improve the new federal science and technology strategy."
4. "To identify and describe the issues which are priorities to Canadians."

(…)

Even though the process has been criticized by analysts, the analysis of written submissions to the process, they could be grouped into a small group of core issues identified by various stakeholders. Among them, were the following:

5. Third party steering of S&T policy.
6. Focus public funding and policy to maximize return on investment.
7. Increasing partnerships among stakeholders.
8. Fostering linkages between science and social issues.
9. Funding federal core research as the backbone of Canadian R&D.

(…)

As examples, these elements may give a fair idea about the way in which Canadians think about the role of S&T in their economy and society.

Components of BC's Biotechnology Innovation Cluster

According to informants interviewed for the study, the province has invested in science and technology for close to a hundred years. The University of British Columbia was founded in response to community interest in having its own university. From the beginning, faculty was expected to conduct research. Moreover, UBC's faculty selection criteria have always implied nationwide (and eventually in the US) search and selection of the best researchers available funds could afford. Although not as old, other major universities in the province share this characteristic.

Even though always expected to generate useful knowledge, pressure for social returns on investment increased in the eighties. In the view of our informants, universities respond to the same mission-oriented view of science. Some of our interviewees regard the culture of support for S&T as a consequence of the role that scientists played in WWII.

Canadian universities informally embraced the Bayh-Dole Act, whose aim was to encourage the utilization of inventions produced under federal funding, and to encourage collaborations between universities and commercial concerns to promote their utilization, for the benefit of the national economy.

The federal government provides funds for development of research infrastructure in universities through the Canadian Foundation for Innovation (CFI). Its mission is: "To strengthen the capability of Canadian universities, colleges, research hospitals, and other not-for-profit institutions to carry out world-class research and technology development". An important issue is that most of its funds are provided on the condition that they are matched with equivalent funds from provincial governments and business. An important ingredient in its mission is the set of criteria with which it evaluates projects for funding [CFI 2003]:

"Infrastructure funded by the CFI supports research that:

?? leads to major breakthroughs;
?? improves our quality of life;
?? helps clean and protect our environment;
?? generates results that will lead to economic growth;
?? generates results that will be transferred to health practitioners, community groups, teachers and decision-makers."

Taken only as an example[ii], this text shows the degree to which both the mission-oriented view of S&T, and the requirement of interaction among actors in the system is built-in, in the functioning of major components in the system.

Funds for research itself are also closely associated to matching funds that must be provided by beneficiaries of their results. As different organizations in the provinces vie for funds provided by the federal government, they must ensure that their provincial government matches those funds, and that business provides another portion.

Even though there are funds available for basic research, many scientists have shifted to more applied fields. As reported by researchers interviewed for the study, this has been a change that hasn't taken place at universities because of directives born within them, but rather they are the product of a gradual shift in the availability of the funds they compete for. This change has taken place in the last two decades. In adapting to this shift, they have developed a network of contacts with industry that has provided with a wide range of research topics, in a relationship that has grown stronger with time.

In BC diverse organizations have been created within this context, with explicit goals for linking industry and academia. Organizations like the *Advanced Systems Institute* (ASI) dedicate a significant portion of their resources to create links between industry and scientists in the natural sciences.

On the other hand, new spin-off firms grow out from universities, in order to commercialize technologies developed in research projects. They are not necessarily created by researchers themselves, since a significant proportion of them are researchers by vocation. Enterprises can be started by their graduate students, or they may rely on support provided by university-industry transfer offices (UILO's) in order to license their technologies. Sometimes new firms are created to exploit the new technology, with the UILO's providing help in IP management, finding venture capital, and in building the right business team. Other times they help in patenting and setting up arrangements for licensing of the new technology. At some institutions, the university and the researcher share property of the patents, but in others they remain the researcher's.

At larger universities, the UILO cannot possibly have the capacity to process all of the invention disclosures made by research personnel. This work requires a set of competencies in order to understand high-level technologies and to quickly assess their commercial value. These liaison offices train high-level personnel for the task, and work through a network of personal contacts with business men and venture capitalists, with whom they collaborate in assessing the commercial possibilities of the technologies.

In BC it is clear that the knowledge base that fuels the growth of the innovation cluster, through the creation of spin-offs and through continuous contacts with businesses. Differing from what has been reported elsewhere

[Longhi 1998, Lindholm Dahlstrand 1999], no major “anchor” firms are performing such function in the case of the biotechnology cluster in BC, although big league companies have spun out of the university and grown to be world-class pharmaceutical firms. Rather, the biotechnology cluster has grown from knowledge “spillovers” coming out of the university [Goldfarb and Henrekson 2003], that economic opportunities. The quantity of young and more mature firms increases with time, since the density of firms attracts others, for which business and technological opportunities are also created.

Around this core set of firms many other organizations of different types have developed, among whose major objectives is to facilitate networking and alliances between other participating organizations and individuals. Also because of the quantity of young firms, as well as the special character of their needs (such as the specialized recruitment of high-talent personnel in the international market, for example), other organizations have also appeared within the cluster, or arrived to it. They supply firms with all kinds of support services: contract research, clinical trials, market intelligence, intellectual property management, specialized human resource management, scientific and technical information, high-technology component supply and development, and so on). It is this density of service and support organizations what enables firms in the network to remain technologically and business-wise competitive. But, in order to achieve that competitiveness the cluster, as a cluster, must remain competitive with respect to other jurisdictions.

Venture capital has consistently been available for the biotechnology industry in BC for close to two decades. Even during the economic hardship of recent years, there is capital available for this industry, although not as plentiful as it used to. Venture capital, as other resources and processes in the system, also works fundamentally through personal contacts among those who play complementary roles in interacting organizations. Uncertainty inherent to technology development, to the assessment of its future commercial value, and to the possibility of assembling a business team capable of realizing it, make the use of formal interaction rules all but irrelevant. Among those interviewed, it was unanimous that it is honesty and trust what enables them to collaborate repeatedly. Trust means two things: confidence that opportunistic behavior will not be incurred, and confidence in the technical ability to achieve results agreed upon.

Venture capital and human talent are attracted to BC by another factor that province government officials and trade association leaders are acutely aware of: tax incentives. Venture capitalists, young firms, mature firms investing in BC’s biotechnology cluster, and specialists that arrive in the province have significant tax incentives available to them. Province government officers and business leaders interviewed report that the province government is perfectly aware that the province is competing with other regions, in other countries as well as within Canada. And this variable is carefully monitored by business analysts [see MacKay-Dunn et al. 2002, for example].

Both federal and province governments are very sensitive to issues raised by trade associations and by ONG’s. Government officers not only are accountable for rapidly responding to them, but they also promote business associations that can articulate those issues, in sectors where networks are only beginning to emerge. Government officers also carefully monitor the needs of industry, since the economic vitality of the province depends enormously on its capacity to attract and retain business talent and capital.

A representation of the system as described, and of its dynamics, is presented in Figure 1.

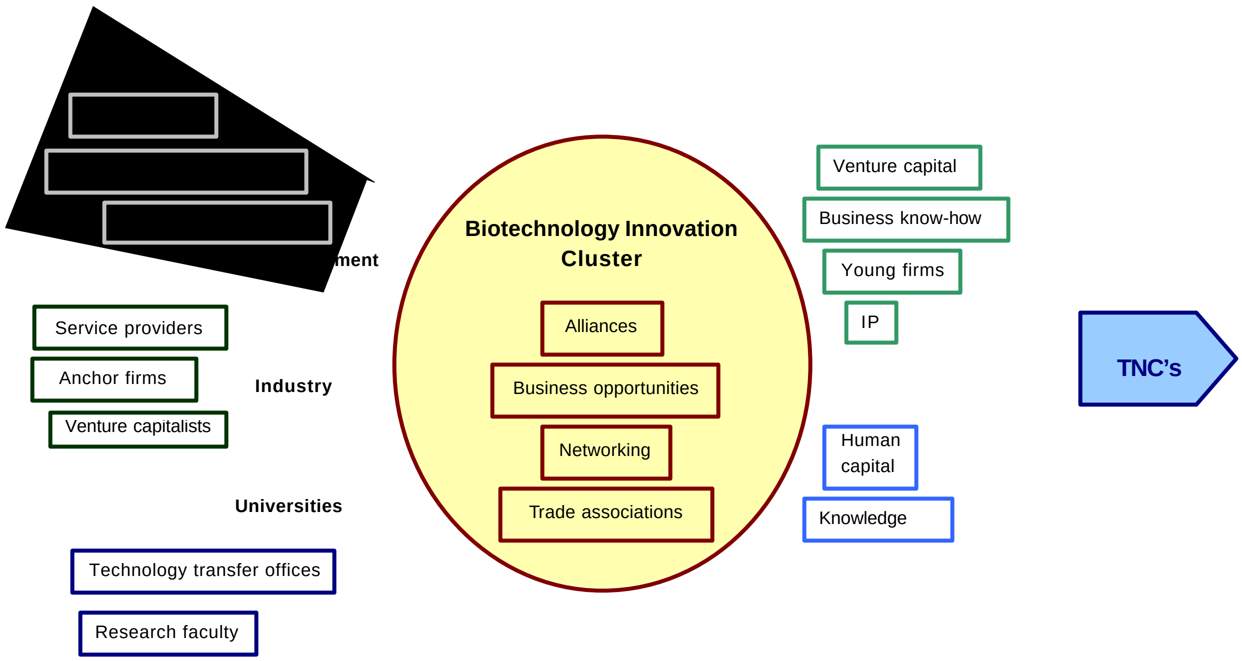

Fig. 1: A MODEL OF THE BC BIOTECHNOLOGY INNOVATION CLUSTER

What is it that gives coherency to the system? An outstanding aspect throughout it is that, according to our interviewees, their interactions are not governed by formal rules, or by explicit or clear cut signals among organizations or among individuals. However, it is not a chaotic system, or one that behaves randomly: there is a principle that governs its coherency. In the words of the leader of a non-lucrative organization dedicated to the development of biotechnology in the province:

"That coherency does come down to one thing. And that one thing, I think, is a system of values. And those values deal with what we want for our children, and for our children's children. We want the best opportunities in British Columbia. Most of us have come to BC from somewhere else. And most of us have kids. (…). British Columbia doesn't have a deep industrial background. BC is a great place to visit, and a great place to have your resort, and a great place to live. But it doesn't have the same job opportunities as other places, in the terms of the knowledge based economy. And people who look ahead (…), and say yes, I want to make some money, and that's fine. But more than that, I want what I do to count. Then, what you want to do is to leave a legacy that is better for your kids, and I think that is a common value that keeps this rolling; and it is the fact that, unless we invest in the right things today, and some of that may be painful, we have to give up spending on other things. And unless we invest in the right things today, we won't have the right opportunities for our kids, for our grandkids, and so on. And we won't be able to have a social structure that makes sense. We have been living with a social structure because we have been able to sell trees and dig up minerals, and we would not have that standard of living, and I don't think we would have that social coherency of the country, the culture of the country if we didn't have that ability to invest in it (…) and I think that is a collective understanding of the people involved".

The Mexican Research Centers Network Case

In spite of their resemblances, there are sharp differences between the BC case and the Mexican case. Among the most obvious is the fact that the first one displays a full-fledged effort to develop its innovation capabilities, with a strong network of interacting organizations that operate in complementary roles. Interorganizational learning is a full blown and explicit effort among them.

In the Mexican case, these processes are in their initial phases [Cimoli 2000, Casas 2002]. A few universities and public research labs, for example, have lead in the development of innovation networks. However, fieldwork has produced data that not only points to a severe instability of those networks, but that also points in the direction of structural barriers that undermine their development. Though these barriers grow out of many aspects that are cultural in nature, our aim is rather to concentrate in those interaction patterns (structural arrangements) that occur among actors in the system, that are not functional for its development.

In trying to explain problems observed in the development of innovation networks in Mexico, it is evident that many institutional arrangements are not conducive to that development. We use here the term "institutional arrangements" in its conventional meaning in the literature on institutionalism. Rather than reviewing that literature still another time, we hope to make our use of it clear by operationalizing it to be applicable to the Mexican case.

As has been reported in general for Latin America, "(…) results of the top-down mechanisms have been well below expectations of policy makers, in the sense that the historical low involvement of industry in knowledge and innovation activities — the reversal of which is one of the main goals of such mechanisms — has not substantially improved." [Sutz 2000, p. 279]. Latin American national innovation systems have developed into weak entities [Alcorta and Peres 1998], with only partially working policy measures, and weak ties among their components. Countries in the region have lost ground, relative to others with whom development indicators were similar a few decades ago. Indeed, the question we want to explore is why, given the presence of many elements needed for an innovation system in several parts of Mexico, those few networks that have arisen have proved to be unstable and, in many cases, ephemeral.

In our exposition, we start with the public R&D labs in the country, and build around them by identifying those other organizations with which they are interacting. In the process we hope to show that those interactions have only *some* of the characteristics that have proven useful elsewhere. In contrast, we will also attempt to show that many interactions in fact represent *structural barriers* to the development of regional systems of innovation.

Public R&D labs in Mexico have been created in the last three decades. Their mandate is to develop and transfer technology to industry. In some cases, small and medium manufacturing industries should be the preferred customer. Each one of them is dedicated to certain technologies, and to certain industries. However, it has not been easy for them to define their vocation. Some of them have had unstable periods that have set back their efforts to develop mature and productive research groups, and to develop significant technological competencies, with the corresponding infrastructure.

In the necessary learning that this process implies, public research labs have lacked role models to follow. Their interactions with other organizations have not been able to set into patterns that their long range development requires. This is not necessarily a consequence of a lack of internal resources in order to be able to define development strategies, but it is rather a consequence of the instability and the weak correspondence between those strategies have with what other organizations provide to, and expect from them. The specific inter organizational configuration (as an organizational field) that is needed requires a series of processes at the organizational and institutional level [Barley and Tolbert 1997] in order to develop. Once they are in place, interaction patterns begin to act as a network in which organizational forms tend to converge.

Once stabilized, these patterns of interaction become "institutional arrangements" [Niosi et al. 1993] that provide support, momentum, information, and incentives to the development of local, regional or national strategies, which in turn make the consolidation of regional or national systems of innovation possible. Paralleling Niosi's phraseology, the system of interaction patterns among public and private, large and small firms, research institutions, and government agencies responsible for the development of S&T has not developed consistently. In as long as these interactions can be of a technical, commercial, legal, social or financial nature, research labs will be faltering on these domains, as the flow of those resources fails to become stable in any direction. And to the extent that this is the case, the funding, regulation, and development of S&T, will be failing. Put in other terms, what is happening in Mexico is that a set of clear and "understood" rules that organizations need for productive interaction is still not present.

Components of Innovation Networks in Mexico

According to official documents, and as reported by interviewees, the National Council for Science and Technology (CONACYT), has had a good disposition for the creation of public research labs. However, in view that some research labs operate profitably in other countries, and following recommendations from the World Bank, for example, CONACYT officers persistently press public R&D labs in order to become profitable, or at least to constantly increase their direct income from the services provided. However, this expectation seems to loose sight of the fact that those research labs that are taken as models operate within mature industrial markets, in which R&D is taken for granted as survival strategy for industrial firms, a situation which is not the case in Mexico.

Diverse government agencies, whose mission is to administer resources, promote economic development, and enforce applicable regulations, interact with public labs through individuals that have a training that can hardly be thought as adequate to understand their specific needs. As can be seen through the analysis of documents that record their participation in the research centers' boards of directors, their participation is very limited. The same is true for industry associations' representatives. This participation is usually limited to overseeing that bureaucratic norms are being complied with. From interviews with administrative and higher management in the labs it is clear that they must frequently be very daring and imaginative in order to comply with those rules, and at the same time be able to honour in time commitments to clients.

In more than one way, it is clear that not only do actions of government agencies lack coordination among them, but also that they disregard objectives and priorities set forth in the National Program for Science and Technology. This becomes clear not only from the interviews, but from the analysis of S&T indicators that are well known. Halfway into the present administration's period, it is clear that the goals set forth in that document were defined without consultation with stakeholders and parties involved (the scientific community, as well as industry and even some governmental agencies). Goals were unrealistic, to the degree that they lack connection to government agencies' day to day activities.

Client firms have hired centers' services mostly in two kinds of contracts: a) for routine technical work, not part of their main production processes, but for secondary functions, such as complying with routine environmental requirements, and b) modernization of equipment (using off-the-shelf technologies), and expansion of production facilities. As reported by their representatives interviewed for the study, client firms do not seem to have technology development as part of their competitive strategies, but rather to assimilate available technologies in order to exploit less value-added markets. In the case of subsidiaries of transnational corporations, technology is developed in their headquarters, and transferred to their foreign subsidiaries, where cheap labor is the main benefit.

Industry associations are currently in a transition phase. Until a few years ago, by law all firms should be affiliated to them, which ensured for them stable and numerous memberships. This fact prevented the development of skills needed to read and promote attention to industry's interests. As this requirement was withdrawn, trade associations have worked hard to develop those skills, but the corresponding learning process is still slowed down by a natural and deep-rooted skepticism in firms. As described below, however, in a few cases trade associations begin to have a significant role in technological issues.

Universities have for decades dedicated themselves to solve massive educational needs derived from demographic growth. In order to do that, their recruitment processes have been designed almost exclusively to expand teaching capacity. Faculty hiring practices having nothing to do with scientific and technological productivity and, consequently, only a very small research capacity has developed. Their budgets all but ignore this function. There are a few interesting examples of interaction between research personnel in public labs and university faculty, mostly around graduate programs.

Only in very few universities has a significant development of intellectual property management and technology commercialization capacity taken place. What researchers that eventually develop some technology usually do is to search by themselves the way and means to commercialize it. Or else, they simply let the patents (where there are any) expire.

Some Relatively Successful Networks

In spite of barriers such as those describe above, some innovation networks have grown, in which many of the processes of trust, joint learning, and knowledge flow can be observed. They meet many of the requirements identified in the specialized literature. Some examples can be cited from what field research has found in the central part of Mexico, where recent industrialization of middle-sized cities is taking place:

Large mechanical power transmission in agribusiness, were sold to the sugar industry, in an effort to start a modernization process in it. The corresponding research lab assimilated and adapted the required technology, in order to produce some of their largest components. As manufacturing of those components required the participation of industry, the technology was transferred to some firms, and a trade association started around common technological problems. The research lab was the main driving force in the process. However, as major economic decisions, made at the federal level, completely changed the outlook for this industry, the association languished and had all but disappeared at the time of the study. Sugar plants lost interest in modernization along this path.

Repair and service of turbo machinery has been an opportunity to an R&D center in order to respond to external pressures to increase its income. Engineering services were offered to a transnational corporation. As sound technical performance was demonstrated, new contracts grew and gave way to a high-technology joint venture, located in the same region. The company has eventually been able to contract R&D projects, with considerable success, and research personnel collaborate with higher education institutions in the region. The research lab has also contracted with other firms that provide design and repair services of turbo machinery to federal corporations. However, this market has not been consolidated, due to (not necessarily legitimate) entry barriers, created by TNCs' in an attempt to lock out local firms. However, a strong joint learning process has taken place between these firms and the lab's research personnel. This process deals with the way in which to commonly identify and state firms' needs, and with the development of solutions. On the other hand, this learning process is occasionally set back by changes in the lab's personnel assigned to the project.

Anti-corrosion treatment for metal surfaces is a technological need for some other firms in the region, that are served by a different research lab. The R&D center has been able to enter that market, by helping firms that need that technology to produce domestic appliances. Its services have been contracted in order to identify and solve problems in the production process and to design, installation and expansion of production lines. However, most firms that are subsidiaries of TNC's require only technical routine services from a certified laboratory, and occasional use of expensive specialized equipment available in the lab. Product technology is usually the property of the company's headquarters abroad. Besides, expansion and installation of production lines is done by using off-the-shelf mature technologies. Income is significant, but services provided do not represent a real opportunity for the lab to develop higher-level technological competencies. This R&D center is also active in providing short courses in anti-corrosion technologies, which gradually strengthens trust and knowledge flow between the center's personnel and technical personnel in the firms. In turn, this has helped researchers to understand the firm's current technological needs, and their operating rhythms, which are not easy for the center to deal with.

Another R&D lab has worked with a transnational company which at the time was partially controlled (50%) by Mexican capital, in the development of an agricultural machinery prototype. Services provided started with engineering projects for production line facilities and machine tools. As confidence in the center's capacity grows, the company contracts its help in the development of a new generation prototype for one of its main products. However, in spite of the joint learning process that ensued among the firm, its (mostly foreign) clients, and the lab's personnel, the prototype did not make it through preliminary market clinics, at the time the company's control changed hands in favour of transnational capital. The corresponding network did not continue to develop common technological competencies, and services fell back to routine engineering projects.

A Metal mechanical process equipment modernization project was contracted for a formerly Mexican-controlled TNC. The firm needed equipment modernization and development as an alternative to off-the-shelf but expensive machinery available in the international market. The joint learning process initially seems to grow into capital goods development but, as reported to our research team by company's representatives, the firm is not planning to continue with it. The reason stated is that, even though price and technical quality of the service is satisfactory, development time is too long for it to meet market entry and competitive pressures. Also, price advantage is reduced because the center needs to rely on components not available in local markets, and their procurement increases costs and delivery times. As technology in the industry continues to advance, the center's competencies will fall behind, unless it invests considerably and specializes in it.

Seeking new markets and technological opportunities, a center is entering the market of flow-measurement processes and equipment for non-standard fluids. Services provided to a government corporation are directed to expert third-party assessment of services and equipment delivered by TNC's, with the aim of providing the government corporation with a validation that they meet promised performance. The R&D lab has worked in developing the corresponding expertise, in order to design and build measurement equipment, but local component suppliers have been unable to deliver them with the quality, cost, and time-delivery required. Some local suppliers have disappeared from the market, leaving the center unable to comply with contracted warranty parameters. Again, the foreign component suppliers option increases costs and delivery times, and the supply-development process seems long and uncertain.

Even as these problems are not necessarily different from those reported in the literature for other regions [Revilla-Diez 2000], they clearly illustrate how the absorption capacity of firms around them becomes a structural barrier for the development of the corresponding networks.

Industrial and S&T Policy Challenges in the Mexican Case

Possibly the most fundamental need in Mexico for effective S&T policy would be the recognition of the economic value of investment in S&T. Overall R&D expenditure is well below standards for OECD countries, and not precisely in the first places for Latin America. Investment should consistently be directed, to the strengthening of research infrastructure. A greater proportion of its GNP% (currently at 0.4%) should be consistently invested in S&T.

Due to the country's barely new democracy (it was ruled for 7 decades by one party), its institutions are still struggling to learn new patterns of interaction, while political parties are still more worried with access to power, than with long range economic and social programs for the country. It has fallen to state and municipal authorities to develop more direct programs, like tax incentives, for example, in order to attract foreign direct investment, and foster innovation. A learning process is still in place, since many initially successful regional programs falter, as international competition obscures volatile advantages in this field [Palacios 2001].

Even though recent federal administrations have set forth six-year programs in the area of S&T, interviews with public R&D labs' research personnel and higher management consistently point to the consequences of lack of coordination among government agencies. This lack of coordination deeply undermines their ability to contribute significantly to goals set forth in national S&T programs.

Research is needed in order to better understand the processes through which organizations in the system (such as trade associations, for example) can articulate their interactions with others, in order to seek common programs and policy issues that should be pushed in this domain. Efficient inter organizational learning will not occur spontaneously. Only knowledge-driven policy measures can ensure the right economic and regulatory environments for innovation and R&D, and for the development of regional systems of innovation.

Another set of problems lies around the set of industrial and economic policies that may accelerate the evolution of the country's entrepreneurial culture in the direction of investment in R&D. Businesses have operated for decades in a context in which it is easier to buy or licence foreign technology, transferring economic and social costs to the customer, or else to use off-the-shelf technologies, in order to exploit low value-added markets. The fist generation of industrialists in the country is handing over control to the second one. The capacity to build up innovation and technological competencies depends on the arrival of a new generation of managers to the firms, since those entrepreneurs whose firms grew up in the import-substitution period lack vision and capacities in this area. Our alternative is to head into direct competition with Chinese labour.

Policy Challenges in the Canadian Case

"Canada's Innovation Strategy was launched in February 2002. Its goal is to move Canada to the front ranks of the world's most innovative countries.

"Between May and November 2002, more than 10,000 Canadians gave their views and ideas on creating a culture of innovation and learning across Canada. The input from this process will go towards a national action plan to be developed following the National Summit."[3]

Canada's *Innovation Strategy* has been assigned to address four major challenges:

1. "Creating New Knowledge and Bringing it to Market More Quickly"
2. "Developing Skills for the New Economy"
3. "Setting the Right Business and Regulatory Environment"
4. "Strengthening Communities Across Canada"

In response to this initiative, organizations like *Canadian Manufacturers and Exporters* have taken to themselves the task of closing the "excellence gap", which is the distance between Canadian levels in several economic and innovation performance indicators, and that of the best in the G7 group. Many other organizations throughout the country continue to generate actions and programs in the same spirit.

However, in the view of Canadian policy analysts interviewed for this study, Canada does not have a well-defined, S&T policy. *De facto*, three areas have been favored by governmental budgetary decisions: a) strengthening research infrastructure, b) facilitating immigration of highly-skilled personnel, and c) expedient use of R&D tax credits in favor of Canadian-controlled, privately held firms. Both, policy analysts and government officials, view government agencies' roles as responsive towards needs expressed by community NGO's and business associations.

Coupled with the mission-oriented view of science and technology, this system would seem to lack a process-oriented view of S&T policy: the design and operation of organizations, whose roles would be related mainly to the promotion of S&T *per se*, with economic and social goals set in the range of several decades. Process-oriented S&T policy systems are exemplified by those of Mexico and Korea. However, only the second of these countries has set long range goals, and a set of institutions whose mission is to constantly evaluate progress toward those goals.

Would a process-oriented S&T policy system, with long range goals be a real need? According to leaders of some arms-length government organizations related to science and technology in British Columbia that were interviewed, it is. In their view, programs fail as ideological swings in government officials take place, and benefits of long-range programs fail with them. According to some interviewees, for example, programs that have two decades functioning, and out of which world-class firms have grown out, completely lose momentum as newly arrived politicians discontinue them for ideological reasons.

The outlook for the biotechnology innovation cluster seems positive in the short run, but it may prove to be fragile. Its major attractor is not industrial infrastructure, but the social and natural environment. Since it is an "industry" that consists mostly of trade in intellectual property, it is quite mobile. So far, emigration to the US has not proven to be a significant danger, since many of the scientists that formerly moved south of the border are beginning to come back. So far, the industry has been able to hire business talent from the US, but it continues to depend on its capacity to attract people from abroad, since the needed expertise in international arenas is not available in Canada:

"All of our senior people are imported. And that's hard. It's hard to move Americans (…) boy, … to get someone to move across that 49th parallel, … it's tough going (…) but once they're here, fortunately Vancouver is a lovely place, so fortunately, when they have been here for a year, then they never want to go back, so …".

So far, inflow of talented scientists has been steady, even replacing researchers that have earned enough from their technologies for early retirement.

However, Taiwan's efforts to develop its own biotechnology industry by recruiting top notch scientists at all costs, is a danger looming in the horizon.

On the other hand, competition for federal resources and for venture capital, firms and talent, is strong among jurisdictions within Canada, and it seems to be getting stronger by the day. British Columbia depends, as all of them, on federal government's subsidy, through the allocation of funds for research, for example. In order to retain its biotechnology innovation cluster vitality, it must continue to be more attractive than other jurisdictions, whether within the country or internationally.

In spite of the current success of the BC biotechnology innovation system, or maybe precisely because of it, it seems that it will be hard to avoid the current globalization trend [Buctuanon 2001], as the system integrates with the international flow of knowledge [Leydersdorff and Meyer, forthcoming]. Part of this flow of technology is in terms not only of intellectual property that is transferred to more developed economies, but also in terms of people and, most importantly, firms. All of these components and products of innovation systems flow from less to more developed economies, where institutional arrangements that facilitate de development and commercialization of new technologies. Beyond the jurisdictional strategies for competition in preserving and developing its innovation system, the global system's dynamics develops forces that may be beyond local or national policy measures to constrain.

The asymmetry and differentiation in the global system of innovation provides the networked system with complexity for a next round of competition for innovative integration. Is the BC biotechnology innovation system ready for it?

As it happens, interviewees repeatedly reported the emigration of firms that carry intellectual property and technological and business expertise with them, as they are being bought by transnational (US controlled) firms.

British Columbia's ability to retain trained talent, entrepreneurial vocation will increasingly depend on a close partnership between industry, provincial and federal governments.

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End Notes

[i] We distinguish between mission-oriented views of science and technology and process-oriented views. The first are in use when social, economic goals are first set in public policy, and then S&T are recruited in order to harness their power in achieving those goals. Process-oriented views are in use when policy instruments are put to work in order to promote scientific and technological development, with the implicit aim of eventually deriving beneficial consequences from them. The set of policy instruments, be they programs, funds, institutions, have as their main task to oversee the functioning of the system.

[ii] The complete content analysis of this kind of texts will be presented in a second paper, forthcoming.

The Economic Effects of Mexico's Integration into NAFTA: Seven Years After its Operation

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Abstract

In the short term, the creation of free trade zones results in two different effects on foreign trade: Trade Creation and Trade Diversion Effects. The net effect of the economic regional integration is the comparison between Creation and Diversion Effects. If the Trade Creation Effect is higher than the Diversion one, the economy benefits from the integration process.

The main purpose of this investigation is to show the economic effect of the regional economic integration within NAFTA for the Mexican economy. The Effect of Trade Creation in trade between Mexico and the USA and Canada will be compared with the Trade Diversion Effect obtained in Mexican trade with its other principal trade partners: EU countries, Japan and ALADI members. The effects will be measured by total trade as well as by industry. Additionally, the changes in the intra-industry trade between Mexico and the USA, and Mexico and Canada will be studied as another positive result of Mexico's integration into NAFTA.

Free Trade Agreement and its Effects

According to the integration theory, a free trade agreement is the simplest way of achieving the idea of regional free trade and is considered the second best solution of the free trade in general .(Balassa, 1964; Ladyka, 2000).

The previous statement defines a free trade agreement theoretically. In addition in the real free trade agreements the member countries have total liberty on the duties imposed on the non-member countries. Besides this kind of agreement, there are so called real free trade agreements the members of which have the complete liberty to determine the customs duties with other countries completely eliminating the customs duties or other barriers in the commerce between them which permits the insignificant flow of the production means and the harmonization of the economic policy. (Lawniczak, 1974)

WTC defines two kinds of real free trade agreements: bilateral and multilateral. .P. Kindelberg and W. Röpke, developed this economic integration theory (Bozyk, 2003). They assume the integration process as another way of expanding the market in terms of free trade and free market; in other words, this way company of different countries can collaborate with each other as if they belonged to the same country without inner frontiers that make the flow of labor, capital, products and services between countries more difficult.

According to the concept of free market and trade, the highest world level of well-being can be achieved when the invisible hand of the market decides on the collocation of different production methods, the optimum location of the production according to the world scale and the international trade size and structure. In the case of a free trade it has to do with the curtain simplification considering the few number of member countries conforming them. From the point of view of the member countries, a free trade agreement is attractive principally for two reasons:

1. Member countries have the freedom of applying its own economic overseas policies to the non-member countries without affecting their sovereignty.
2. It can increase the efficiency in the management of the resources and also, the living standard of the habitants.

Free trade agreements have a wide range of positive effects over its member countries such as:

- ?? Static and dynamic
- ?? Allocation
- ?? Accumulation

?? Location

From the theoretical point of view, the so called static effects which appear when there are no structural changes (for example, available means of production or changes in the production or consuming structure) or changes in the available technology (changes in the technical progress and its structure) are of major importance. One important feature of the static effects is that they appear in short periods, that's why they are also known as short term effects (Misala, 2001).

Short Term Effects

The short-term integration effects are subdivided according to different criteria. The most useful division is the one that divides the commercial effects and non-commercial ones (effects on investments, production and consuming).
In free trade agreements, the short-term there are following commercial effects:

?? The effect of the trade creation
?? The effect of trade diversion
?? The effect of trade deflection

The trade creation effect is the only one of the three mentioned above that affects only the member countries, while the other two effects are about changes in the trade with non-member countries. (Misala 2001)
The trade creation effect consists of the appearance of new flows of commerce that did not exist before because of the market liberalization. This effect is the result of the differences between the production costs and the appearance of the new incentives in the exchange between the member countries of a free trade area caused by the elimination of the barriers that slowed down the trade development between them, but maintain the trade barriers with other countries.

The trade creation effect is related to two other effects: production and consumption. The production effect analyzed by J.E. Meade (Bozyk, 2003) consists of a marginal case after the trade liberalization in the least efficient country (higher production costs and less consumption diversification), the production of goods disappears and becomes the subject of the imported goods. The domestic goods are then substituted by the cheaper ones with better quality produced in one of the member countries which means that in a parallel way they are a part of the consumption.

The size of the production and the consumption effects as well as the intensity of the trade creation depends on several factors. They basically rely on the supply and demand flexibility of the member countries. Within a regionally integrated group, the offer multiplies (as well as the demand) and its flexibility is normally higher than the one of each the member countries if they operate independently. That's why the duty for different countries can be changed: fiscal duties, for example, can be seen as expansion or protection. From this point of view the appearance of the creation effect is very important.
According to the international trade theory, the development takes place when the partners receive measurable benefits of their development although they are not divided equally.
The benefits are given:

?? When the available production facilities between the partners are different; as well as the production intensity, allowing the development within and between the industries.
?? Differences between the partners from the point of view of the possibilities of achieving the benefits according to the scale of the economies in the production and distribution process, and the probabilities of satisfying the changing preferences of consumers and investors. The difference plays a major role in the situation where similar production functions appear or the ownership of facilities and their use intensity results as the trade development within the industries.

Several factors determine the importance, intensity and structure of trade between and within the industries. One of them is the Gross National Product per capita: the higher and more equal level between the member countries, the greater is the importance of the commerce within the industries.

The second effect of the trade liberalization is the trade diversion effect which means the change of direction of the commerce flows. This occurs because of the substitution of the suppliers from the non-member countries (although they can be more effective, with lower production costs) by the protected less efficient ones from the member countries, which competitiveness grows because of the non-trade barriers within the FTA.

The production and consumptions effects appear because of the diversion effect, related to member and non-member countries. Its importance relies on the intensity and the development level of specialization: the higher intensity and importance of specialization within the industry trade, the less negative for the non member countries the diversification effect including the effect of production and consume.

The reason is because in the specialization and trade within the industries, the adjusted costs of the structural changes (related to production and consumption) are lower.

The comparison of the size of the trade creation effect versus the trade diversion effect shows the net effect of the regional integration. If the trade creation effect is greater than the one of the diversion, it means that the creation of the free trade agreement area has a positive effect on the resources allocation. On the other hand, when the trade diversion effect is greater than the creation one, the loss from the lower trade between the member countries and the non-member countries is higher than the benefits result from the increase in the trade between the member countries.

The difference in the production costs between the member countries should be analyzed before the creation of a free trade agreement. If the differences are greater than the differences between the member countries and the other ones, even the major reduction in the commerce exchange with the other countries, which increased inside the area, can have a positive influence on the resources collocation in it.

The sum of the trade effects of creation and diversion is known as the gross trade creation effect and can have the form of the trade expansion or trade suppression, The gross effect is a way of measuring the global integration without considering if it is caused by the duties suspension or another trade barriers or because of the change in the importations from non-member countries with the goods bought from the member countries.

The deflection of the trade is related to the self-determination right of each member country in the creation of the importation conditions applied to non-member countries. As a consequence, member countries can impose different duties on the same products from the non-member countries. This allows the importation of products (and services) from non-member countries with higher trade barriers. Member countries have less trade barriers imposed to the importation of goods and services.

The deformation trade effect in a free trade agreement is possible only theoretically because in practice, to counteract this effect countries use different forms in probing the origin of the products that are the subject to this kind of agreements.

The appearance of the deflection trade effect is not the only result from the creation of a free trade agreement without the clear specifications of the original rules. Another effect is the deflection in the production structure. When the trade deforms, one can’t exclude the structural changes of the production that might be irrational from the economic point of view.

The deflection effect in trade and production can be accompanied by deformations in the international flows of production facilities especially in the capital investment and technical skills. In this case, we are talking about the dynamic effects.

From the 60’s of the XX century, the necessity of preventing the deflection trade effect called the attention applying certain laws such as the rules of origin. Investigations related to this problem was started by B. Balassa (Balassa, 1964) and continued later by H. Shibata (Shibata, 1967) who introduced the term indirect deflect trade into the literature which means that a member country of a free trade agreement applies high duties (or other discrimination tools against imports) to the products from a member country, and lower duties to the same product from non-member countries.

The attempts to offset the deflection trade effect in the free trade agreements applying the original rules produce high costs and are not very effective. Besides the application of the rules of origin, the total supply of manufactured goods in the member countries and the trade between them can be complemented by the non-member countries imports; but the different import duties apply are not the same within the zone. This results in an artificial differentiation of price of the imported product, the one produced domestically in the trade between member countries.

The difference in costs and prices of goods within the member countries of a free trade agreements allows the appearance of certain effect: suppose that in one of the member countries the supply for goods increases provoking a decrease in its price. This makes the domestic producer limit the goods production (production effect) while the consumers increase their purchases (consumption effect). The difference between these two effects implies the appearance of the creation of trade effect in the zone.

With a greater goods demand in that country, the new domestic price increases in comparison to the previous price. The domestic good producers increase the production (production effect) but according to the original rules it is not possible to reduce the price of the goods to prevent imports without achieving the consumption effect.

Long Term Effects

The dynamic effects in a free trade agreement reflect the incentives in the economic growth. The clue is the growth rate of investment, employment and the investment yield and work, in free competence conditions. The positive effect of these factors is the result of:

?? Efficiency improvement in the usage of the production facilities and a change in the economic structure and trade between the member countries.

?? The achievement of the scale economy and the production area, and the distribution and increase of the technical area.

The economic rate of growth also depends on the level and growth of the effective demand because a free trade agreement might cause:

?? An increase in the demand of the imported goods (at the same time the dynamic of importations and exportations increases because of the accelerated development between the member countries).

?? An increase in the demand of investments because of more competitors, the tendency of the rationalization of production increase because of the new investments; and also the probabilities of the suppliers of capturing part of the demand that used to be reserved for the products of the non-member countries.

?? The creation of multiplying effects focused on better use of the production facilities, an increase in the Gross National Product, the consumption and maybe on the workers competitiveness.

The influence of the demand and supply factors in the economic growth cause additional effects, in particular those related to the creation and diversification of the investments analyzed by Machlup (Machlup, 1986). The names given to these phenomena are similar to the effects in the trade area, but they are not the same. They are the answer to a question: if after the creation of a free trade agreement the investment volume within the group increases, is the sum of investments and the group higher or stays the same? On the other hand, when the investments go from the non-member countries to the member-countries we are talking about the diversification effect. When free trade agreements are created, the total sum of investments in the global economy increases because of the creation effect.

A difference in the interpretation of the trade effects is in the case of investments. Not in all the cases the diversification effect is negative, while the creation effect is considered positive. It depends on the marginal effectiveness of capital. If the marginal capital effect is bigger in the zone than outside it, the investment diversification from the non-member countries to the member countries can mean a more effective use of capital.

An increase in the partners investments can influence the growth of their total gross product only when the potential savings are greater than the volume of investments or if they can induce a major ability in savings and maintain this at a high level.

The dynamic effects of the free trade agreements are reflected also in the external and internal benefits in the day to day companies operations.

Some of the external benefits are:

?? The growth of the size of the companies that allow them better negotiations, easier access to the capital, more efficient use of labor and a better position in the non-member markets.

?? The development of more efficient production skills and also a bigger quantity of competitive products on the international markets.

The external benefits for the companies in a free trade agreement are the result of a dispersion of different economic effects. A company achieves a better position in a market (i.e. offering products with better quality), the positive effect is transferred to the companies that cooperate with it, the suppliers and the consumers, stimulating technological innovations. The integrated markets of the zone also accelerate the rate of technical knowledge trade between the companies and households.

Commercial Short Term Effects in NAFTA

The objective of the following investigation is to analyze the commercial effects in the short term that appeared in Mexican foreign trade as a result of North American Free Trade Agreement after 7 years of its coming to force. One of the important aspects to consider is the importance of the trade creation effect with the free trade agreement countries on the changes in total foreign trade of Mexico. Another one is to analyze the influence of the mentioned effect on the intra-industrial trade. The last but not least one is to revise the trade diversion effect as a result of the agreement.

TABLE 1: THE COMPARISON OF TOTAL EXPORT AND IMPORT IN MEXICO IN 1993 AND 2000 IN MILLION DOLLARS ACCORDING TO THE HARMONIZED SYSTEM CLASSIFICATION.

	Export			Import		
Section	2000	1993	change	2000	1993	change
1	1,342.3	908.4	433.9	2,587.0	1,581.8	1,005.2
2	3,920.4	2,106.1	1,814.3	3,783.7	2,124.0	1,659.7
3	49.6	41.3	8.3	454.5	441.5	13.0
4	2,949.0	855.1	2,093.9	2,115.7	1,405.1	710.6
5	16,691.4	7,625.8	9,065.6	5,935.7	1,833.7	4,102.0
6	4,631.4	2,029.8	2,601.6	10,465.6	4,429.8	6,035.8
7	3,918.4	1,496.6	2,421.8	12,944.9	11,309.6	1,635.3
8	661.2	214.2	447.0	1,224.1	386.8	837.3
9	547.6	390.5	157.1	840.6	588.7	251.9
10	1,342.4	1,301.2	41.2	4,896.3	2,454.6	2,441.7
11	11,295.4	2,094.0	9,201.4	10,039.7	3,416.0	6,623.7
12	471.2	304.3	166.9	257.1	307.6	-50.5
13	1,930.5	774.6	1,155.9	1,538.0	620.5	917.5
14	930.7	310.8	619.9	905.7	281.4	624.3
15	7,014.0	3,033.9	3,980.1	15,345.2	5,711.2	9,634.0
16	69,720.7	18,859.1	50,861.6	71,598.8	22,185.0	49,413.8
17	29,093.4	7,286.3	21,807.1	17,803.6	2,377.7	15,425.9
18	4,628.9	1,237.8	3,391.1	4,749.7	2,023.1	2,726.6
19	11.0	3.1	7.9	37.5	11.9	25.6
20	5,193.8	1,546.3	3,647.5	2,557.2	1,919.1	638.1
21	25.5	3.0	22.5	10.2	10.9	-0.7
22	51.0	0.0	51.0	4,275.6	7,344.5	-3,068.9
23	35.1	102.9	-67.8	91.1	0.0	91.1
Total	166,454.9	52,525.1	113,929.8	174,457.5	72,764.5	101,693.0

Source: self-calculated data on the base of the Mexican foreign trade statistics, INEGI 2002.

Since the effect of the trade deflection appears when the rules of origin do not exist in NAFTA case it's difficult to detect it since the treaty includes very precise rules of origin as to the goods importation.

According to the statistics of the Mexican foreign trade in the year 2000, i.e. 7 years after NAFTA came to force, Mexican export increased from 52.5 thousand million dollars in 1993 to 166.4 thousand meanwhile import increased from 72.8 to 174.5 thousand million dollars as it is shown in table 1.

Some of the branches of economy contribute to the increase of both, export and import in total Mexican trade. These branches are: tool machines and electronic equipment, the transportation equipment, textile industries, mineral and chemical products, steal and not-oxidant metals and the products made of them. During the same period of time significantly decreased the participation of the following Mexican products: fats and oils, paper and carton and their derivatives.

In its quantitative presentation, the trade creation effect clearly indicates that the changes in total Mexican foreign trade are result of NAFTA.

As one can see, after 7 years NAFTA came into force 94% of the increase of Mexican exports and 82% of its imports are due to the treaty. It's important to emphasize that the increase in trade with the USA has the major importance while Canada is still behind despite the fact that it is the second commercial partner of Mexico.

Because of the trade creation effect the participation of the countries that belong to the group on total Mexican trade increased 6 percentage points in exports and 10 in imports (reaching accordingly 91% and 74%).

TABLE 2: THE COMMERCE CREATION EFFECT IN MEXICO AFTER 7 YEARS (1993-2000) NAFTA CAME TO FORCE IN THE QUANTITATIVE PRESENTATION (IN MILLION DOLLARS).

	Export			Import		
Section	Total NAFTA	USA	Canada	Total NAFTA	USA	Canada
1	381,676	382,445	-0.8	972,065	808	164.0
2	1,446,357	1,434,930	11.4	1,490,998	1,323	167.8
3	-5,301	-5,281	0.0	69,881	64	5.5
4	1,613,423	1,581,189	32.2	482,194	452	30.3
5	7,888,904	7,692,403	196.5	3,099,934	3,083	16.9
6	1,199,386	1,149,088	50.3	2,440,677	2,325	116.1
7	2,072,018	2,054,634	17.4	7,535,786	7,373	163.2
8	407,224	406,461	0.8	655,642	646	9.3
9	148,758	148,840	-0.1	110,110	84	26.3
10	511,021	504,591	6.4	2,250,184	2,185	64.8
11	8,629,414	8,540,604	88.8	5,854,703	5,768	87.2
12	183,967	181,444	2.5	-37,577	-38	0.2
13	1,083,416	1,062,949	20.5	604,791	590	15.0
14	458,350	444,461	13.9	693,774	608	86.1
15	3,903,646	3,864,515	39.1	7,301,324	7,092	209.1
16	48,916,249	48,384,736	531.5	37,793,018	36,930	863.6
17	21,133,582	20,370,296	763.3	12,233,934	11,341	892.9
18	3,236,265	3,229,461	6.8	2,104,267	2,048	55.8
19	7,081	7,081	0.0	12,280	12	0.0
20	3,431,618	3,418,185	13.4	880,382	857	23.9
21	9,480	9,453	0.0	-1,692	-2	-0.1
22	28,211	26,574	1.6	-3,492,967	-3,401	-92.3
Total	106,684,745	104,889,059.0	1,795.5	83,053,708	80,148	2,905.6

Source: self-calculated data on the base of the Mexican foreign trade statistics, INEGI 2002.

Analyzing the effect of the trade creation in its indicative (table 3) presentation it is possible to conclude that Mexican export to NAFTA markets increased more than import. It can be explained because of the better access that Mexican products received when entered the market of the partners in comparison to the access offered the USA and Canada (the asymmetry in the deduction calendar).

The branches of the manufacturing industries such as industrial textile (especially the wool products, knitted and complete garment) showed the highest increase in export. Also the branches like transportation means (first of all automobiles), machines, tools and electronic equipment (computer equipment and the spare parts, electronic and electric devices, record and sound equipment), equipment and devices of different kinds (especially the optical ones: photocopying machines, photo cameras, glasses and products that contain fiber optical lenses) and food industry (alcoholic drinks- beer and tequila, sweets without cocoa, refined sugar and food prepared on the cereal base)presented rapid growth while the increase in the traditional branches (agriculture, footwear, wood and paper industries) was slower. As to the agriculture products the least increase was observed in the export of live animals and animal-derived products, fats and vegetable and/or animal oils.

TABLE 3: THE EFFECT COMMERCE CREATION IN MEXICO AFTER 7 YEARS (1993-2000) NAFTA CAME TO FORCE IN THE INDICATIVE PRESENTATION.

	Export			Import		
Section	Total NAFTA	USA	Canada	Total NAFTA	USA	Canada
1	1.47	1.47	0.64	1.93	1.84	3.12
2	1.74	1.75	1.67	1.81	1.80	1.89
3	0.85	0.85	0.66	1.27	1.25	1.97
4	3.26	3.25	3.73	1.46	1.44	2.14
5	2.55	2.55	2.46	3.15	3.22	1.34
6	2.14	2.10	6.30	1.91	1.88	4.21
7	2.62	2.61	10.93	2.95	2.92	6.00
8	3.06	3.07	1.60	3.19	3.18	4.76
9	1.39	1.39	0.86	1.22	1.17	9.37
10	1.89	1.88	7.02	2.09	2.09	1.92
11	5.93	5.94	4.90	3.41	3.40	5.05
12	1.73	1.73	1.81	0.72	0.71	1.50
13	2.58	2.58	2.56	2.35	2.33	4.61
14	2.81	2.76	12.03	5.63	5.06	529.30
15	2.73	2.73	3.14	2.76	2.75	2.81
16	3.77	3.82	2.15	3.42	3.41	4.26
17	4.13	4.45	1.92	8.73	8.47	14.89
18	3.71	3.73	1.62	2.57	2.56	3.51
19	3.75	3.75	0.00	3.31	3.31	0.00
20	3.35	3.35	2.31	1.95	1.94	2.53
21	5.61	5.66	1.90	0.76	0.76	0.52
22	0.00	0.00	0.00	0.31	0.31	0.15
Total	3.41	3.45	2.15	2.77	2.75	3.62

Source: self-calculated data on the base of the Mexican foreign trade statistics, INEGI 2002.

As to the major increase imports, it was presented practically by the same manufacturing industries: transportation (passenger automobiles thanks to the liberation of the import politics), machines, tools and electronic equipment, textile, diverse equipment and devices. One of the products, which caused import considerably, increase and is not shown on the export list, is precious metals and stones.

In case of Canada there are some differences in trade in comparison to the USA since in Mexican exports of this market the major increase was shown by such industries as: precious metals and stones followed by plastic and its manufactures (boxes, cages and decorations), paper and carton and its manufactures, especially paper and carton boxes and containers. The chemical industry products take the second place (organic and chemical products, soaps and detergents, photographic products) and foodstuffs (sweets without cocoa, food preparations and alcoholic drinks). Precious metals and stones showed major increase in both import and export. The following industries were wood and its manufactures, paper and carton products, manufactures of ceramic stone and glass (ceramic products for chemical and technical usage, mirrors, security glass, and ampoules). Similarly to the USA, textile products and automobile industry showed high increase during this period.

One of the conditions for intra-industrial trade to be more intense is the income per capita in the member-countries which needs to be high and according to similar levels. In case of Mexico and its NAFTA partners this condition cannot be complete so no significant changes in intra-industrial trade between Mexico and the USA, Mexico and Canada can be observed. In trade between Mexico and the USA the number of branches with the intra-industrial trade indicator Ri (Grubel &Lloyd, 1975) Ri > 0.5 increased from 61 in 1993 to 64 in 2000, while the number of branches for which this indicator is Ri > 0.7 passed from 30 to 38. Similarly there were registered the changes in the intra-industrial commerce between Mexico and Canada: the number of branches where the indicator Ri>05 increased from 23 to 33 while Ri >0.7 increased from 16 to 21.

The intra-industrial commerce between Mexico and the USA deals with: food industries, mineral and chemical products, rubber and its derivatives, leather and its derivatives, textile, stone, ceramic and glass manufactures, computer equipment, electric and electronic devices, telephone devices, stoves, optical devices and toys. In the industries such as: gunpowder and explosives, carpeting, accessories, hats and headdress, furniture and watchmaker devices the indicator Ri<0.5 in 2000 in comparison to 1993 which shows the decrease of the intra-industrial commerce in these branches.

On the contrary, in case of live animals, fertilizers, essential oils, soaps and detergents, editorial products, umbrellas and parasols, zinc products, vehicles for train roads, automobiles, Ri increased over 0.5 which means the increase in intra-industrial commerce. In case of Canada intra- industrial commerce deals with such industries as: fishing products, processed food, chemical, organic and inorganic products, essential oils, photographic and textile, stone, ceramic and glass products, automobiles, musical instruments, furniture, and others. As to agriculture, cotton in the textile industries, iron/steal smelting, zinc, optical products, instruments and devices, the indicator Ri decreased from 0.5, which means that intra-industrial trade in these areas decreased as well. On the other hand, this trade intensified during the analyzed period in such branches as: automobile industry, electronic devices, industries that produce boilers, motors, stoves, heaters, conditioners, zinc manufactures, and essential oils among others. (see the indicator of intra-industrial Mexican commerce with NAFTA countries in 1993 and 2000 according to the Harmonized System table in Appendix).

Analyzing the trade diversion effect in Mexican foreign trade due to NAFTA it is possible to conclude that because of the relatively little importance shown by countries from the rest of the world in the Mexican foreign trade this effect is almost invisible. This is due to the fact that in real numbers Mexican trade increased with the three groups of countries.

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According to the analyzed period the trade with the European Union, LAIA, and Japan increased although its rhythm was different for each country. As it’s shown in table 5, in exports the major increase was achieved in sales to the countries of European Union (the diversion effect appeared in sales to Austria, Belgium and France as the exports to those countries decreased the level in comparison to 1993), followed by countries of ALADI while export to Japan stayed practically at the same level even in some branches like mineral, chemical and plastic products, footwear, transportation equipment, instruments and optical devices the decrease was observed which proves the existence of trade diversion effect.

TABLE 4: PARTICIPATION OF SELECTED COUNTRIES IN MEXICAN FOREIGN TRADE IN 1993 &2003 (IN %).

countries	Export 1993	2000	Import 1993	2000
NAFTA countrie	84.5	90.7	64.4	74.4
USA	81.3	88.7	62.9	72.1
Canada	3	2	1.5	2.3
EU countries	5	3	10.6	5.2
Japan	2.3	0.8	6.6	4
LAIA countries	2.9	1.6	2.9	2.4

Source: self-calculated data on the base of the Mexican foreign trade statistics, INEGI 2002.

TABLE 5: THE DIVERSIFICATION EFFECT OF MEXICAN COMMERCE AFTER 7 YEARS (1993-2000) NAFTA CAME TO FORCE IN THE QUALITATIVE PRESENTATION FOR SELECTED COUNTRIES.

	Japan		European Union		LAILA Countries	
Seccion	Exports	Imports	Exports	Imports	Exports	Imports
1	14.26	0.37	10.81	-107.96	4.79	100.97
2	10.06	0.40	49.18	-10.36	13.25	68.81
3	0.57	0.05	0.81	-22.04	1.98	-64.48
4	28.11	-1.29	129.64	93.28	92.27	92.99
5	-95.09	20.46	477.40	67.05	34.76	126.01
6	-42.08	20.01	405.09	345.46	566.51	154.88
7	-0.37	132.41	33.26	99.75	136.68	56.04
8	0.30	0.58	13.71	26.77	4.43	22.07
9	0.19	0.62	-0.57	10.02	0.86	89.05
10	0.70	9.73	8.77	72.61	44.74	28.49
11	16.32	-7.75	41.67	88.78	57.81	71.92
12	-2.79	-0.82	-34.21	10.56	6.68	-0.59
13	67.71	0.92	15.00	48.35	16.17	19.00
14	68.24	294.76	-18.48	-1.77	9.16	3.13
15	42.72	388.89	8.68	-65.36	65.38	530.08
16	178.48	1809.17	481.48	1217.70	247.17	168.62
17	-36.93	748.28	616.77	69.09	-132821.00	700.33
18	-33.17	29.78	79.74	7.50	22.15	51.01
19	0.00	0.07	0.14	0.80	0.52	0.54
20	-11.98	17.57	1.70	2.58	26.37	1.02
21	-0.17	-0.80	160.48	1.01	0.01	0.08
22	1.99	-702.59	5.15	-614.28	4.80	-289.31
Total	207.08	2,760.90	2,486.19	1,337.53	1,223.66	1,931.12

Source: self-calculated data on the base of the Mexican foreign trade statistics, INEGI 2002

The behavior of Mexican export to different regions of the world can be explained through the access difference of Mexican products to different markets, i.e. in case of the UE it is important to consider the Free Trade Agreement signed by these countries that came to force in the middle of 2001 as well as the treaties signed with some countries of LAIA such as Chile, Columbia, Venezuela. The import behavior was similar for three groups of countries, i.e. all the products they bought increased in the similar quantities except for Japan where import increased more.

TABLE 6: THE DIVERSIFICATION EFFECT OF MEXICAN COMMERCE AFTER 7 YEARS NAFTA CAME TO FORCE (1993-200) IN THE INDICATIVE PRESENTATION WITH SOME COUNTRIES.

Seccion	Japan		European Union		LAILA Countries	
	Exports	Imports	Exports	Imports	Exports	Imports
1	2.64	2.09	1.33	0.55	25.05	9.17
2	1.93	1.39	1.57	0.84	2.59	1.51
3	1.66	4.69	1.43	0.43	7.70	0.29
4	3.14	0.72	3.63	1.51	6.90	2.19
5	0.81	15.15	1.44	2.47	1.45	1.61
6	0.92	3.14	3.82	1.31	2.60	2.15
7	0.81	2.10	1.81	1.47	2.53	2.99
8	1.70	1.56	3.25	2.17	4.94	2.05
9	1.42	2.75	0.83	2.55	6.95	4.48
10	14.50	1.76	2.02	1.30	2.07	1.35
11	3.27	0.81	1.64	1.46	1.54	2.24
12	1.60	0.17	0.17	1.53	12.50	0.96
13	49.37	3.17	1.83	1.47	1.82	1.84
14	182.00	4.76	0.62	0.92	3.82	5.61
15	2.53	2.48	1.04	0.90	1.60	2.39
16	5.47	2.01	1.85	1.42	1.78	1.61
17	0.11	7.41	8.58	1.17	0.58	4.79
18	0.22	1.13	7.26	1.03	2.60	2.90
19	0.00	0.00	3.46	1.15	2.83	0.00
20	0.16	1.41	1.50	1.11	4.21	1.06
21	0.23	0.07	8.52	0.99	1.05	2.12
22	0.23	0.34	0.00	0.26	0.00	0.13
Total	1.17	1.73	1.97	1.17	1.82	1.91

Source: self-calculated data on the base of the Mexican foreign trade statistics, INEGI 2002

As to the rhythm of increase, it was very similar for both export and import (oscillated between 1.17 in case of export to Japan and 1.97 in export to EU) but it was found out inferior of the increase in trade with the countries of NAFTA (3.41 in export and 2.77 in import). What calls the attention is that the least affected branches in Mexican trade with the countries outside the treaty were those of minor importance inside the NAFTA. According to table 6 in exports to Japan the sales of wood pasta, paper and carton, stone, ceramic and glass manufactures, precious stones and metals increased faster.

In export to the UE countries the major growth was registered in processed food, leather manufactures, pieces of art besides the transportation equipment and diverse devices that constitute an important area for NAFTA and experimented the increase in their sales to these markets. The export to Latin American countries presented the highest rhythm of increase and concentrates on the products with less transformation degree, for example, agriculture, wood and its derivatives, footwear and headdress.

The diversification effect is very clearly presented in the imports form the European countries since their total increase was the slowest and besides the imports of different areas has declined which shows that they were substituted by import from NAFTA countries. The following industrial branches affected by this phenomenon are: agricultural products, fats, vegetable and animal oils, precious stones and metals, machines, tools, electronic equipment. In case of Japan, the most affected industries are the following: processed food, textile, footwear and headdress. The import to LAIA countries was the least affected since the only negative effect is shown in the import of fats and vegetable oils, footwear and headdress industries.

Conclusion

NAFTA caused the appearance of the commercial effects which appear in case of the formation of a free trade area such as diversification and creation effects. Since the volume of total Mexican commerce with all its partners increased after 7 years the Treaty came to force, the first effect that can be noticed is the trade creation effect due to the fact that commercial exchange with NAFTA partners almost tripled. The USA market continues to be the most important one for the Mexican products as well as a supplier for the national industry. Despite the increase of the trade volume the importance of Canada for Mexican economy is still low.

The increase of trade with the USA let Mexico become the second USA commercial partner (after Canada and before Japan, China and Germany). The commercial exchange with this country is concentrated on automobile and electronic sections, textile industry and chemical and plastic products. The importance of the processed food increased as well. The intra-industrial commerce analyzed from the point of view of the number of participating industries doesn't show any significant changes although analyzing it according to the type of industry point of view it is possible to conclude that this trade has intensified more in the industries which the participation in the Mexican foreign trade increased more.

Despite the fact that the trade diversion effect in trade with non NAFTA members countries cannot be seen clearly because of the increase of the exchange volume it can be concluded that imports coming earlier from the EU, Japan or LAIA countries was partially substituted by the products coming from NAFTA countries even when the majority of them signed different free trade treaties with Mexico during this period. The increase of Mexican trade with the partner countries can get worse in the near future due to the change of the preference conditions it still primarily in the US market. China's joining WTO and the free trade agreements negotiated by the USA with Chile and Central American countries can cause the erosion of the privileges that Mexican exports receive and decrease the competitiveness of Mexican goods in the same market. On the other hand, the future enlargement of the European Union can affect the interest that European investors might have in Mexico which can also cause the decrease in Mexican trade with those countries.

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Appendix

Contact the author for the table: The indicator of Mexican intra-industrial trade with NAFTA countries in 1993&2000 according to the Harmonized System Classsification

Growth of the Spanish Multinational in Latin America during the 1990s

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Abstract

During the 1990s, Spain changed from a net recipient of foreign direct investment (FDI) to one of the most important investors in Latin America. Cultural ties and market opportunities in countries such as Argentina, Brazil, Chile and Mexico, proved to be fertile ground for Spanish FDI as measured by alliances, co-operation and mergers and acquisitions. Fieldwork in this article identifies trends and directions of Spanish acquirers targeting Latin American companies with an emphasis on the 1990 to 2001 period. The relative strength of market size, wage differentials and cultural affinity helped in explaining the link between strategic decisions of the Spanish acquirers and their choice of geography and industrial sector.

Introduction

The emergence and growth of the multinational corporation (MNC) is intimately related to foreign direct investment (FDI). According to Ietto-Gillies, Meschi & Simonetti (2000) and Cazorla (1997a), an interesting example of this process is the 'late' arrival of the Spanish MNC and the predominance of their FDI decisions throughout Latin America during the 1990s. Going international is a complex decision resulting from internal and external factors and which can take different organisational forms including agency contracts (e.g. indirect exports), alliances, co-operation, acquisitions, and 'greenfield' investments. The research that follows identified systematic differences in the trends and directions of Spanish acquisitions in Latin America. These trends reflected strategic decision-making with regards to targeted industrial sector and targeted geography while, at the same time, allowed testing for the predominance of alternative explanations of competitive advantage in the expansion and growth of Spanish MNCs. The assessment then provided a basis for some speculation about the evolution of Spanish firms as multinational corporations.

The document proceeds as follows. Section 2 reviews the context of internal and external incentives that explain the emergence and growth of multinational companies in general and of Spanish MNCs growing in Latin America during the 1990s in particular. Section 3 details the data set and research methods. Section 4 offers an assessment of trends and directions mergers and acquisitions involving Spanish MNCs in Latin America from an industry, country and individual company perspectives. Section 5 is the final section offering a summary, tentative conclusions and potential for future research.

International growth and the rise of the Spanish MNC

Cross-Border Growth through Acquisition

The standard model of internationalisation has the firm moving abroad incrementally as it acquires knowledge about distant markets. Incremental growth certainly occurs as envisioned by the so called 'Uppsala Model' (Johanson & Vahlne, 1977 and 1990; Johanson & Wiedersheim-Paul, 1975). According to the reviews documented by among others Levi (1990, 392-6) and Martínez Mora (1998), cross-border growth has also been explained as resulting from processes encompassing issues around non-transferable knowledge, capital availability, protecting secrecy and indirect diversification (i.e. provide portfolio diversification for shareholders). Internationalisation has also been rooted in strategic moves such as anticipating (or responding to) foreign firms establishing in domestic markets, and anticipating (or responding to) close competitors establishing in foreign markets. In other words, internal incentives leading to international growth are intertwined with visionary strategies and the search for competitive advantage (Kim & Mauborgne, 1993; Lyles, 1990; Melin, 1992; Peng, 2001; Stimpert & Duhaime, 1997; Werner, 2002).

Decisions leading to FDI have been closely associated with trends and directions in cross-border mergers and acquisitions. In particular, Andersson, Johanson & Vahlne (1997) has extend the incremental internationalisation framework to incorporate “organic” acquisitions. This as the mode of the evolution of the firm’s geographic scope often involves the acquisition (i.e. buyer initiated purchases) and divestiture (i.e. seller initiated purchases) of whole operations. Decisions leading to FDI, however, have been far from immune to perceived host country risks and target market conditions (such size and potential growth of the market). Empirical work around the behavioural concepts of risk and specifically the risk perceptions and propensities of decision-takers, has pointed to the importance of behavioural aspects in the process by which acquisition candidates are selected, the characteristics of pre-acquisition evaluation and negotiations, and their effects over post-acquisition integration (Pablo, Stikin, & Jemison, 1996). Hence, rather than responding to the merits of the proposed investment, the development of cross-border activities could respond to managers' preferences for control (Petrou, 1997) and even the whims of the chief executive (Davies, 1987).

Fieldwork amongst European and North American firms, therefore, has suggested that the selection of investments leading to internationalisation could result from opportunistic and even fortuitous strategies. Research on FDI and cross-border growth, however, has primarily built using country or country-industry level data to determine whether firms are 'leading' or 'lagging'. In practice, this has implied that all firms from a country or country-industry are considered to have homogeneous strategies - they are either all responding to visionary, opportunistic or fortuitous diversification moves. There is thus an extant need to enrich explanations offered by FDI theories to incorporate questions of 'who', 'where', 'why' and 'when', particularly around the study of how MNCs conceive and execute their strategic diversification moves through the link between the acquisition processes, internationalisation and their outer context (Chesnais & Simonetti, 2000; Ietto-Gillies et al., 2000 ; Kim & Mauborgne, 1993; Melin, 1992; Rivoli & Salorio, 1996; Stimpert & Duhaime, 1997)

Competitive Advantage and Internationalisation

In acquiring or divesting operations firms are rearranging the ownership of assets. As Lichtenberg and Siegel (1987) point out, firms rearrange ownership of assets when one firm lacking a comparative advantage relative to another firm with respect to a given operation sells it to that second firm. According to Porter (1987, 46), an enterprise can profitably expand its activities abroad provided its corporate strategy succeeds in truly adding value, that is, in providing tangible benefits that offset entry costs. For instance, diversifying in a way that shareholders cannot replicate. Otherwise, the cost of entry (either through start-up or through acquisition) would be greater than any potential future prospects. Since a) an organisation must bring some significant competitive advantage to the new unit (or the new unit most offer a potential significant advantage to the parent organisation) and b) the more attractive a new industry, the more expensive it is to get into, then it is more likely that international diversification takes place in an industry where the organisation has a proven track record and managers have industry-specific knowledge and experience. However, global presence by itself does not confer competitive advantage (Gupta & Govindarajan, 2001). International or even global presence allows the MNC opportunities to adapt to local markets differences, to exploit economies of scale and economies of scope, to tap into optimal locations for activities and resources, and to maximise knowledge transfer across locations. But each of these opportunities can be associated with significant obstacles and challenges that prevent MNCs from exploiting them optimally.

Whereas Porter (1987; 1990) emphasised the achievement of a 'rent' or superior (i.e. above-average) profitability, Hu (1995) emphasised a firm's ability to compete as the source of competitive advantage in international markets. Crucial for that ability is the transferability of a firm's advantage between different units. The transfer of capabilities (or key ingredients), however, must result in advantages relative to competitors and relative to alternative modes of operation (Hu, 1995, 74). Success is contingent to the organisation gaining an advantage relative to rivals at home and abroad, relative other forms of organisation, relative to actual and potential competitors, and relative to the ability of the firm to sustain the source of differentiation through time. Firms will gain an advantage abroad to the extent that unique-, firm specific, industry specific and country specific advantages (or their ingredients) are successfully transferred and the resulting advantage is, at the same time, unavailable to indigenous players.

Advantages at home may be different to competitive advantages abroad when the advantage (or a key ingredient thereof) is not mobile internationally, the advantage itself loses value in the target country or requires the presence of complementary assets[1] (Hu, 1995, 75-6). For this view, international growth could result in unrelated diversification (across industrial sectors) when, for instance, firms transfer the results of an innovation process (rather than the innovation capability itself) or superior management capabilities.

Hu (1995, 85) also considers that, in selecting a foreign production model, firms should consider factors of relative geographical and cultural proximity, which make for a better understanding of local conditions. Indeed, the relevance of cultural proximity in FDI decisions has been viewed as fostering or hindering location decisions (Kogut & Singh, 1988) as well as having an impact in MNC performance (e.g. Gomez-Mejia & Palich, 1997). The influence of cultural proximity in FDI decisions implies that on going relationships between firms and amongst individuals (i.e. social networks) or between value-adding activities (i.e. technological networks) could influence the choice of partners and FDI targets (e.g. Hennart & Larimo, 1998), the nature and purpose of co-operation agreements as well as the contents of information flowing through that agreement (see further Ellis, 2000; Gulati, 1998; Rauch, 2001). If taken to its extreme, the role of cultural proximity could suggests that competitive advantage has little to do with internationalisation decisions because trade is more likely to emerge from social or technological affinity than from market research.

On balance, however, neither market-driven nor cultural affinity dimensions have been able to fully explain trends and directions of FDI. It is thus an empirical matter that which will ascertain whether the emergence and growth of MNCs responds to market or non-market incentives as well as the role of cultural affinity in those decisions. To test the relative strength of different views depicting sources of competitive advantage of MNCs we considered the following formulation:

$$S^n = f(s^n, M_{ij}, W_{ij}, C_j, ?_{i-1j}) \quad (1)$$

where

S^n	Value of FDI decision.
s^n	Financial characteristics of individual transactions.
M_{ij}	Demand (i.e. market size) effect.
W_{ij}	Wage differential effect.
C_j	Cultural affinity effect.
$?_{i-1j}$	Trend (lagged).
N	Transaction number.
i	Year.
J	Country.

Assessing the determinants of individual FDI decisions (S^n) is still full of challenges and an area worthy of attention. Empirical research is inconclusive as to the links between diversification and superior financial performance (Martin & Sayrak, 2003; Palich, Cardinal, & Miller, 2000; Palich, Carini, & Seaman, 2000) while debate also prevails as to the accuracy of constructs to measure diversification (Hyland & Diltz, 2002; Nayvar, 1992; Sambharya, 2000). The nature of FDI decisions also grew in complexity when, as a result of changes in the world economy during the last quarter of the 20th century, MNCs were encouraged to expand into 'emerging' economies (Arnold & Quelch, 1998; Luo, 2001). 'Emerging' markets were perceived to offer significant growth opportunities for MNCs as inefficient markets for corporate control in less developed countries suggested there were opportunities for an acquirer to pay a price not fully reflecting the prospects of a new unit. Indeed, firms from countries lower down the technological ladder can develop transferable advantages relative to firms (existing or potential) in even less developed countries since the former could benefit from advantages associated to a more advanced stage of development and industrialisation (Hu, 1995, 84). Possibilities to exploit market-value and operational differences emerge as in less developed countries large companies are few, financial resources are less abundant and professional management is scarce (Hu, 1995, 84-5; Porter, 1987, 49 and 52).

Growth into 'emerging' markets, however, could poise strategic questions that established frameworks could not resolve (Arnold & Quelch, 1998; Cuervo & Villalonga, 2000; Dharwadkar, George, & Brandes, 2000) and hence attraction of looking at individual decisions of FDI through acquisition. Namely, the potential to learn more about who owns the assets, who is making the investments or what is the motivation to pursue such investments. As mentioned above, the assessment of FDI acquisition decisions is often based on aggregate data and fieldwork typically assumed that all firms in one country and/or in one industry were equally likely grow across borders and for similar reasons. s develThe research that follows compares and contrasts individual and aggregate MNC behaviour. FDI acquisition decisions into lesoped countries were explored by looking at the interaction between idiosyncratic elements of individual transactions (s_{ij}) with demand (M_{ij}), wage (W_{ij}) cultural affinity (C_{ij}) effects. It is worth noting that empirical research around FDI decisions into less developed countries has emphasised cross-border growth into Asian economies (e.g. Chen & Chen, 1998; Luo, 2001; Makino, Lau, & Yeh, 2002; Wong & Ellis, 2002), former communist countries in Eastern Europe (e.g. Beyer, 2002; Buck, Dyomina, & Wright, 2001; Meyer, 2002; Uhlenbruck & De Castro, 2000) or US investments in Latin America (e.g. Grosse, 1992; Len, Daniels, & Arbelàez, 2002; Love & Lage-Hidalgo, 1999a; 1999b; 2000). As a result, a neglected area of research has been to consider and explore diversification decisions of firms in 'recently' industrialised countries into even less developed countries as portrayed by growth of Spanish firms into Latin America.

Emergence of the Spanish MNC

With the exception of Brazil, which was considered an 'independent', firms in most other Central and South American economies have been grouped into a Latin American cluster, that is, grouped into a meaningful category based on shared features such as geography, language, religion and management practice (Ronen & Shenkar, 1985). Whereas Spanish firms have been grouped together with those of France, Italy, Portugal and Belgium in a related but somewhat different cluster of 'Latin European' countries (idem).

Links between Spanish and Latin American firms have a long history as Spanish FDI in the region dates to the 17th century. More recently and as documented in Salmon (1997), López Duarte and García Canal (2002) and Rodríguez (2002), trends and directions of direct investment in Spain have been influenced by globalisation of the economy, European integration, and the role of the public sector. Together these three themes portray the changing character of the economic environment in the last quarter of the 20th century resulting in a continuous process of restructuring in the Spanish economy (mediated through structural and regulatory innovations). At the same time, regulatory changes in many Latin American countries resulted in extensive privatisation of public enterprises and substantial investments from firms whose headquarters were established outside that region (Calderòn, Loayza, & Servèn, 2002; for instance La Porta & Lòpez de Silanes, 1999; Len et al., 2002; Love & Lage-Hidalgo, 1999a; 1999b; 2000)

From the 1980s onwards, Spain (and Portugal) gradually moved from a position of being overwhelmingly a host country to an intermediate status (Chesnais & Simonetti, 2000, 9). Through out this process, growth of Spanish firms characterised by little co-operation with other organisations, relocation (and high degree of control) of resource abroad and full exposure to environmental turbulence in the host country (see further Lòpez Duarte & Garcìa Canal, 2002). For instance, Spanish firms could have entered foreign markets through direct or indirect exports. Indirect exports offers the most secure route for an international trayectory: the firm distributes through an intermediary and while there is little control over commercialisation and resource implications are low. Instead, FDI associates with control of distribution, commercialisation and resource allocation but also with greater exposure to non-diversifiable risk.

Although the internationalisation of Spanish firms accelerated during the 1990s, both Tolentino (1993) and Lall (1996) identify Spain as 'late investor'. In other words, given the relative size and growth of Spain's Gross Domestic Product (GDP), there should have been greater stocks of investments abroad than the level observed at the turn of the Millennium. Some arguments traditionally put forward to explain 'late investor' include limited technological capacity, barriers to international trade, low skills, and poor labour mobility. Among others Canals (1991) and Cazorla (1997a, b) identified a lack of financial sources as the main obstacle to the internationalisation of Spanish firms, particularly for small and medium-sized companies which were often marginalised from government support promoting foreign investment.

Fig. 1 illustrates the country distribution of Spanish FDI during the 1990s and grouped by members of the élite Organisation for Economic Co-operation and Development (OECD), Central and Oriental European Countries, Africa and Asia. According to Fernández and Norniella (1998), a stable macro-economic policy at home and the inclination of Spanish entrepreneurs towards an 'international culture' played an important role in the steep increase of FDI activity at the end of the decade.

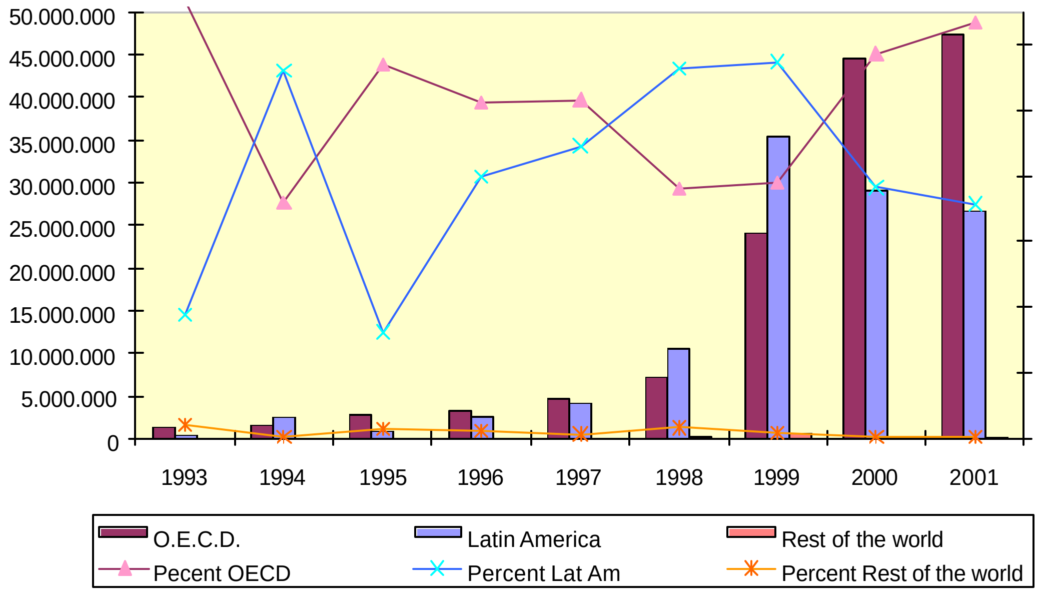

Fig 1: GEOGRAPHIC DISTRIBUTION OF SPANISH FDI , 1993-2001.
(Total amount in thousands of euros at nominal prices and percent of total Spanish FDI per annum)
Source: Spanish Ministry of Economy, Department of Commerce and Investment; and UNCTAD[2].

As measured in nominal prices and as a percentage of total cross border investments, most Spanish investments abroad aimed at OECD countries and Latin America, with a sharp fall in that oriented to OECD countries at the end of the decade. Trends in Fig. 1 also suggested that Spanish FDI in Latin America peaked in 1999 at 35.504.382 thousands of euros (57,4% of total Spanish FDI for that year). Trends in Fig. 1 were consistent with systematic analysis by Ietto-Gilles Meschi & Simonetti (2000, 60), which documented evidence of Spanish FDI (together with that of Portugal and Greece) observing a preference for global links rather than greater integration within the European Union (EU).

Sector distribution of Spanish investment in Latin America for the last decade was also atypical. Investments in financial services (41% of total) and utilities (namely transport and communications at 36%) stand out from investments made in other sectors. Targets of Spanish foreign operations in Latin America during the 1990s were quite different from economic activity in Spain, which was dominated by tourism. Sector distribution of FDI during the 1990s also showed marked differences with cross-border growth of Spanish manufacturing during the 1980s as documented by Nohria and García Pont (1991), Rubalcaba and Gago (2001) and Bajo Rubio and López Pueyo (2002). At an international level, growth of Spanish financial service MNC's was also atypical. Similar organisations in other OECD countries (and particularly for US-based firms) usually 'lagged' rather than 'lead' manufacturing firms in their degree of internationalisation (Focarelli & Pozzolo, 2001; Tschoegl, 1987, 2002). Moreover, data for US companies supported the idea that banks and other financial organisations 'followed' manufacturers outside the US, and while financial services firms may not locate in the same country they would establish in the same region (see further von der Ruhr, 2000).

Succinctly, growth of Spanish MNCs in Latin America is an interesting phenomenon and one in need of systematic attention. Spanish trade in that region involved relocating non-trivial quantities of resources. For individual organisations this processes represented the greatest level of internationalisation. Anecdotal evidence of trends and directions in aggregate flows of Spanish FDI into Latin America would suggest that the competitive advantage of Spanish firms abroad is different from that at home, pointing to the need of examining the sources of competitive advantage for the Spanish MNC. However, inferences on FDI decisions from macro-economic data risks biased results because aggregate data offers little insights as to who owned the assets, who undertook the investments or what was the motivation to pursue such investments. At the same time, cultural affinity and shared histories between Spain and Latin America offer a unique opportunity to explore how market-based opportunities (namely demand size and wage effects) scored against the potential to build social networks as determinants of FDI.

Sources

The Data Set

Since the late 1980s and by the mid-1990s three quarters of the world's FDI took the form of mergers and acquisitions (M&A). Given that only a quarter of world-wide cross-border growth takes the form of new ('greenfield') investment, one could take the view that FDI pertains more to changes in the ownership of capital and to industrial restructuring than to the accumulation of capital (Chesnais & Simonetti, 2000, 5). This is consistent with the view by Kogut (1983; 1991), Buckley and Casson (1998) and Meyer and Estrin (2001) which considers FDI acquisition decisions as leading to the creation of growth options *ex ante* and sequential growth *ex post*. For these reasons the research on the growth of Spanish FDI focused on M&A activity of Spanish firms in Latin America.

However and as noted by Calderón, Loayza & Servén (2002, 6), direct comparisons of FDI data compiled from balance of payment sources with M&A figures is subject to a number of caveats namely the timing of the transaction, their scope, and the definition of target and foreign countries. First, while FDI is measured on an accrual basis by national accounting systems, M&As are recorded at the time of announcement or closure of each specific transaction. Second, individual transactions may include a sequence of payments over several years. Third, traditional FDI accounting considers net financial flows, that is, outward FDI from a given country is adjusted by the dis-investment abroad undertaken by firms from that country. Unlike FDI accounting, M&A transactions report only the total value of the acquisition abroad, without subtracting any possible sales of foreign affiliates (which would be reported as an independent transaction). Fourth, data on cross-boder M&A may include funds raised in local and international financial markets which would not qualify as FDI. And fifth, there may be methodological differences between M&A and FDI accounting regarding the countrys of origin and destination. Namely, FDI flows are usually compiled on the basis of *immediate* host and *immediate* home countries, whereas data on cross-boder M&A may use different combinations of *immediate* and *ultimate* country. All these facts suggest caution when comparing cross-boder M&A and total FDI for a given country. However, trends and directions of FDI flows and cross-boder M&A transactions reach the same conclusions as to the direction of change rather than its magnitude (Chesnais & Simonetti, 2000, 5).

Empirical analysis presented below is based on a data set created from the SDC International Mergers and Acquisitions database provided by the Securities Data Company and sorted by Standard Industry Classification (SIC) criteria of the US Department of Labor. Data was available between January 30th 1987 to December 31st 2001. A total of 512 cross border acquisitions involving Spanish and Latin American[3] firms[4] were identified, of which 459 considered Spain a bidder[5] (acquirer nation) and Latin America[6] a target. Information regarding the financial value of deals was available for only a sub-set of the data (228 transactions or 50% of total). For this reason the assessment initially moved forward using only the number of deals to test for unrelated diversification while the value of deals was used when different patterns emerged (more below).

Data was also available for the share of total equity owned after individual transactions (399 transactions or 87% of total). Using ownership data, 26 transactions were excluded from the total. This to consider transactions purchasing more than 10% of equity (i.e. "capital social"[7]). Excluding transactions of 9.99% or less allowed distinguishing between investments leading to or creating 'options to expand' from simple financial investments. There were 96 transactions with no data regarding per cent owned after acquisition and these were also excluded. As a result, the assessment moved forward using data for 337 transactions when assessing the number of deals (while testing for related/unrelated diversification) and 228 transactions when assessing the value of the deals (while testing for trends and directions of cross border acquisitions).

Empirical Model

The data set on individual transactions was sorted to include specific characteristics of each country and year to form a panel as specified in model 1 above. This database was the basis to proceed with the empirical assessment of the value of FDI decisions (S^n).

The interaction of financial characteristics of individual transactions (s^n) and the effects of demand (M_{ij}), wage (W_{ij}) and cultural affinity (C_{ij}) constructs was tested to investigate systematic differences between trends and directions of FDI decisions using aggregate and individual transaction data (details of data of 110 constructs used in assessing determinants of the value of individual FDI decisions, S^n are available from the corresponding author). Succinctly, 39 different constructs (35%) provided details as to the financial characteristics (s^n) of each and every one of the 228 transactions were the financial value was available for acquisitions involving Spanish MNCs in Latin America. There were 16 constructs (15%) dealing with terms of trade and degree of openness were identified as potential measures of market size (M_{ij}). Six constructs (5%) considered relative income measures and an index for the intensity of union militancy throughout the work force and were identified as potential measures wage effects (W_{ij}). Eight constructs (7%) considered trends and directions of M&A activity ($?_{i-1}$) and thus accounted for issues such as 'herd effects', growth in the stock of FDI and a reduction in the number of potentially suitable acquisition targets.

Instrumental variables were added to identify transactions involving the most active companies as described in Table 1 and Fig. 3 ($?_1$). Another variable modelled the main recipients of Spanish FDI in terms of number of transactions as described in Fig. 2 ($?_2$). There were eleven instrumental variables (10%) as specified below.

Cultural compatibility has increasingly been sought to provide an explanation as to why domestic and cross-border acquisitions succeed or fail. While favourable financial statements or product synergy may be the initial attraction to an acquisition candidate, it has increasingly been argued that whether an acquisition actually works may have more to do with how well the two organisations' 'cultures' match up. Data to assess 'cultural affinity' (C_{ij}) included dimensions external and external to the firm. External to the organisation, it was important to model the market for corporate control. In particular, 26 (24%) constructs were identified to represent the rights granted to the shareholders by the legal environment as well as the effectiveness of the judiciary to uphold these rights (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998). Dimensions which seem to have been critical to explain growth of MNCs in some Latin American countries (La Porta & Lòpez de Silanes, 1999). At the same time, the internal environment was represented by difference between the rank of Spain and the rank of each individual county as scored in Hofstede's (1991) four indexes of national culture (4%). Stylised features of corporate culture such as those emerging from grounded work by Hofstede are not without critics (Baskerville, 2003; Hampden-Turner & Trompenaars, 1997; Hennart & Larimo, 1998; McSweeney, 2002). However, these indexes have been used extensively in empirical research as measures of national culture and explanations of the interaction between national culture and management (Hofstede, 2002; Williamson, 2002). As a result, the empirical assessment of the 'cultural affinity' construct (C_{ij}) assumed differences between countries were greater than differences between different organisations or differences between organisations in the same industry or sector.

Comparative Analysis

Trends and Directions of Mergers and Acquisitions

Table 1 summarises cross-border acquisitions of individual Spanish firms in Latin America. Data in Table 1 suggested Spanish MNC activity in Latin America could have been the result of a handful of companies as by financial services and utilities stand out from investments made by other sectors. However, an average value per transaction of US$426.08 million for all 228 transactions (with details regarding the transaction's value) suggested that, although most Spanish firms had been involved in six or less transactions, M&A activity between 1987 and 2001 distributed throughout a broad range of sectors. This was corroborated in Table 1 which shows Spanish firms sought equity control in their cross-border growth although the size of individual investments was wide ranging (from US$17.60 million to US$1,420.23 million).

TABLE 1: TOP SPANISH ACQUIRING MNCS IN LATIN AMERICA, 1987-2001
(Major acquirers with seven or more transactions)

	Two-Digit SIC	M&A Transactions				Ownership		
		Num. Trans.	Accumulated Value (US millions)	Rank Value	Average Value (US millions)	Average % of Equity	Std Dev	Rank Equity
Telefonica	48	37	$24,692.18	1	$987.69	60.68	37.37	5

Banco Bilbao Vizcaya A	60	34	$7,765.524	4	$277.34	59.31	31.61	7
Banco Santander Centr	60	27	$12,269.59	3	$766.85	59.66	35.19	6
Repsol	13	17	$17,042.80	2	$1.420.23	65.52	29.11	3
Corp MAPFRE SA	63	11	$123.20	7	$17.60	63.18	22.35	4
Endesa SA	49	9	$3,574.75	5	$397.19	72.59	28.64	1
Union Electrica Fenosa	49	9	$389.68	6	$77.94	67.98	25.00	2

Source: International Mergers and Acquisitions database 2002, Securities Data Company.

Geographic distribution of transactions also raised questions as to the concentration of Spanish investments in Latin America around a few selected companies in a handful of countries. As summarised in Fig. 2, Argentina (87 transactions), Brazil (72 transactions), Mexico (50 transactions) and Chile (44 transactions), were the preferred markets for Spanish firms. These four countries represented 75% of total cross-border acquisitions in the region (253 transactions), with activity in other 13 Latin America countries accruing 25% (84 transactions) of the total.

Figure 3 summarises M&A activity in Latin America per industrial sector (as measured by two-digit SIC Code of target firms). These figures show the most popular sector was Depository Institutions (60 SIC Code) with 48 transactions; followed by Electric, gas and sanitary services (49) with 45 transactions, Communications (48) with 38 transactions, Business Services (73) with 27, and Insurance carriers (63) with 25 transactions. Together these five sectors represented 183 transactions or 54% of total, with 46% of activity in other 21 two-digit sectors (averaging 6.4 transactions and standard deviation of 3.47). Clearly, there was a preference for a reduced number of sectors in a limited number of countries, concentration which did not seem to have played at the strengths of the home country and which suggested that the competitive advantage of Spanish firms abroad was different to that at home.

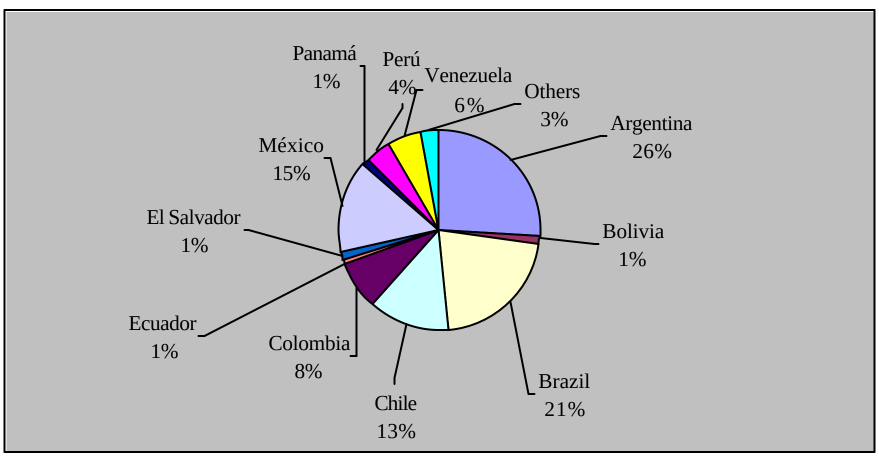

Fig .2: SPANISH ACQUISITIONS IN LATIN AMERICA - DISTRIBUTION BY COUNTRY, 1987-2001
Others: countries with two or less transactions (Guatemala, Guyana, Honduras, Nicaragua, Paraguay and Uruguay)
Source: International Mergers and Acquisitions database 2002, Securities Data Company.

In summary, the review of trends and directions in cross-border M&A suggested that the growth of Spanish multinationals could have been driven was driven by the search of new market opportunities such as unsatisfied demand abroad rather than playing on home country strengths or an excess installed capacity in

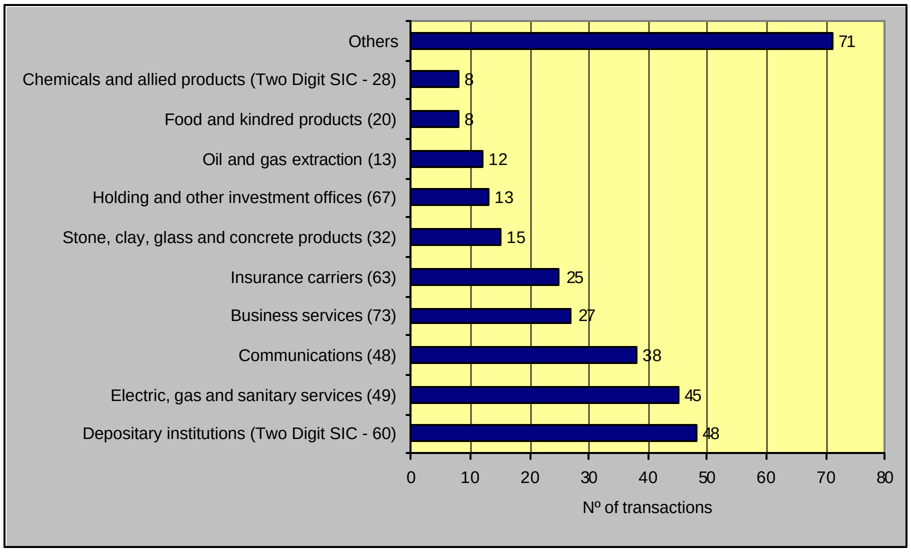

Fig. 3: SECTOR DISTRIBUTION FOR THOSE WITH MORE THAN SEVEN TRANSACTIONS, 1987-2001
Source: International Mergers and Acquisitions database 2002, Securities Data Company.

Spain. In the following section these trends are reassessed to examine the statistical significance of the determinants of FDI investment decisions. In this process, the analysis would shed light as to whether the competitive advantage of Spanish firms in Latin America was different from that at home and the extent to which these decisions responded to visionary, opportunistic or fortuitous diversification moves.

Sector Level Analysis

Following Ietto-Gilles Meschi & Simonetti (2000, 62), an indicator of ´abnormal´ M&A activity (either more or less than expected), was developed while comparing the matrix with M&A flows with another matrix that considered ´theoretical´ frequencies that would appear in the absence of any particular strong link between two sectors. The ´theoretical´ matrix represented the M&A flow that would occur in the absence of any factors that would favour particular relationships (i.e. particularly high or particularly low) between two sectors. The matrix for actual flows and the matrix for ´theoretical´ flows were compared using an indicators based on the chi-squared, where

$$A_{pq} = (? \ (O_{pq} - T_{pq})^2) / T_{pq} \qquad (2)$$

where

p Total number of transactions for SIC code of targets (in Latin America).

q Total number of transactions for SIC code of acquirer (in Spain).

The indicator, A_{pq}, resulted from the square value of the difference between the observed flow, O_{pq}, and the ´theoretical´ flow, T_{pq}. As in the case of the chi-squared statistic, the ´theoretical´ frequency for each cell was calculated by multiplying the row and column totals relative to the cell and dividing by the product by the overall total.[8] A single indicator was estimated for all combinations where the targeted two-digit SIC Latin American industry was the same as the two-digit SIC Spanish acquiring industry. This indicator was labelled related diversification. A second single indicator was estimated for all combinations where the targeted Latin American industry was different from the Spanish acquiring industry. This indicator was labelled unrelated diversification.There were 183 transactions involving related diversification (A_{pq} = 118.0) and 154 involving non-related diversification (A_{pq} = 59.2). Given the ´theoretical´ value, T_{pq} = 83.6, it was impossible to reject the null hypothesis of equal distribution for a chi-squared of 3.84 (with 1 d.f. and 5% significance). Results thus suggested that international investment of Spanish firms were indeed limited to a few sectors, some of these sectors played to their competencies in Spain (i.e. related diversification) while others looked for competitive advantage in a different industry (i.e. unrelated diversification).

To explore which were the most active sectors of Spanish M&A activity abroad, a value for the indicator, A_{pq}, was then estimated for each individual combination of target industry in Latin America and its Spanish acquirer. These indicators allowed insights into specific patterns of diversification then compared to reject the null hypothesis of equal distribution for a chi-squared of 68.77 (with 45 d.f. and 5% significance).[9] Following the US SIC classification for the 1987 census, there were 31 two-digit SIC industries (39%) without any activity at all (see further the Appendix 1 for detailed results). At the same time, there were 14 industries (18%) in where target (in Latin America) or acquirer (in Spain) was active but the indicator, A_{pq}, was not statistically significant. There were 11 industries (14%) where target and acquirer were active but only one was statistically significant. Table 2 summarises these results.As shown in Table 2, MNCs from six Spanish industries pursued unrelated diversification. This trend is perhaps more evident in investment in five Latin American industries where companies were acquired by an unrelated Spanish industry. These are target and acquirer industries with extreme values and one should avoid taking these results to portray the only industries observing unrelated diversification. However, visual examination of individual transactions suggested these transactions were not far apart within the value chain. For instance, Banco Santandar Central Hispano (SIC 60) acquiring a security broker (SIC 62). Results in Table 2 could thus be biased because of the classification method used when sorting by SIC criteria.

TABLE 2: M&A ACTIVITY OF SPANISH FIRMS IN LATIN AMERICA BY INDUSTRY, 1987-2001
(SECTORS WHERE TARGET AND ACQUIRER WERE ACTIVE BUT ONLY ONE WAS STATISTICALLY SIGNIFICANT)

		Target (Lat Am)		Acquirer (Spain)	
SIC Code	1987 U.S. SIC Description	Value of Indicator, A_{pq}	Nº of transactions	Value of Indicator, A_{pq}	Nº of transactions
13	Oil and gas extraction	159**	12	54	2
29	Petroleum and coal products	14	3	178**	16
35	Industrial machinery and equipment	0	0	223**	2
36	Electrical and electronic equipment	60	6	71**	4
44	Water transportation	66	1	113**	5
50	Wholesale trade--durable goods	0	0	335**	2
62	Security, commodity brokers, and services	9	4	83**	1
76	Miscellaneous repair services	83**	1	0	0
80	Health services	128**	4	0	0
87	Engineering and management services	98**	5	0	0
95	Environmental quality and housing	335**	2	0	0
Sum			*38*		*32*

** = Significant with a 95% confidence interval.

Table 3 shows 24 industrial sectors (30%) where target and acquirer were both active and both were statistically significant. These sectors encompassed most of the industries making related diversification and show that cross border activity of Spanish MNCs in Latin America is concentrated in but a handful of industries.

Succinctly, in order to investigate the pattern of foreign investment through cross-border M&A, a matrix was created examining the flow of M&A (number of deals) between pairs of industries (as measured by two digit SIC codes). The aim was to asses whether trends in M&A transactions could help in ascertain links between M&A activity and the competitive advantage of Spanish firms in Latin America. As suggested by descriptive evidence in the previous, an approximation using the chi-square suggested that foreign investment of Spanish MNC´s in Latin America during the 1990s was heterogeneous and concentrated in a few industries. This test, however, was uanble to tell whether related diversification associated with with the successful transfer of competencies, market opportunities and accessing resources to supply foreign markets. In the following section an assessment is made as to the growth of Spanish MNCs in Latin America in terms of market opportunities and environmental risk.

TABLE 3: M&A ACTIVITY OF SP ANISH FIRMS IN LATIN AMERICA BY INDUSTRY, 1987-2001
(SECTORS WHERE TARGET AND ACQUIRER WERE ACTIVE AND BOTH WERE STATISTICALLY SIGNIFICANT)

SIC Code	1987 U.S. SIC Description	Target (Lat Am) Value of Indicator, A_{pq}	Target (Lat Am) Nº of transactions	Acquirer (Spain) Value of Indicator, A_{pq}	Acquirer (Spain) Nº of transactions
1	Agricultural production- crops	336	1	336	1
15	General building contractors	96	2	113	3
16	Heavy construction contractors	91	3	134	4
17	Special trade contractors	168	1	209	2
20	Food and kindred products	185	8	186	8
21	Tobacco manufactures	336	1	336	1
22	Textile mill products	335	2	335	2
25	Furniture and fixtures	334	3	111	1
27	Printing and publishing	83	7	108	14
28	Chemicals and allied products	145	8	129	14
32	Stone, clay, glass, and concrete products	279	15	279	13
33	Primary metal industries	250	4	250	3
37	Transportation equipment	167	2	266	4
38	Instruments and related products	291	4	250	3
39	Miscellaneous manufacturing industries	336	1	336	1
45	Transportation by air	197	7	199	6
47	Transportation services	195	6	150	4
48	Communications	115	38	129	32
49	Electric, gas, and sanitary services	154	45	143	31
60	Depository institutions	132	48	152	55
63	Insurance carriers	136	25	174	16
65	Real estate	162	5	133	2
70	Hotels, rooming houses, camps, and other lodging places	258	7	224	8
73	Business services	141	27	126	23
Sum			*270*		*251*

Country Level Analysis

A second statistical test looked at the empirical significance of model 1 above through a regression model.

$$S^n = ?_j + ?^n ?^n_j (s^n, M_{ij}, W_{ij}, C_j, ?_{i-1j}) + ?^m ?^m_j ?_j + ? AR(9) + ?^n \quad (3)$$

where

S^n	Value of FDI decision.
s^n	Financial characteristics of individual transactions.
M_{ij}	Demand (i.e. market size) effect.
W_{ij}	Wage differential effect.
C_j	Cultural affinity effect.
$?_{i-1j}$	Trend (lagged).
$?_j$	Instrumental variables a) Value of 1 when purchaser was either Telefonica, BBVA, BSCH, Repsol, Endesa, Mapfre or Union Fenosa and 0 otherwise. b) Value of 1 when country was Argentina, Brazil, Mexico or Chile and 0 otherwise.
AR(9)	Autoregresive adjustment
$?^n$	Residual.
n	Transaction number.
m	Number of instrumental variables.
i	Year.
j	Country.

The 110 constructs identified as potential determinants of the value of individual FDI decisions (S^n) were reduced to 20 constructs. See Table 4. Firstly, pre-regression test used cross sections by year (1999 and 2001) as well as countries (Argentina and Colombia) and found 28 constructs were unable to contribute to the assessment.[10] For instance, most of the details as to the financial characteristics of the transaction (s^n) were lost as these constructs overwhelmingly had a value of zero. The reason being that cross-border acquisition of Spanish firms usually involved payments using internal resources (using cash rather than issuing debt or new equity) and were non-contested acquisitions (i.e. transactions were completed the same day they were announced and therefore lacked the need for sophisticated protection mechanism such as pacman, poison pill, lock up, etc.) Secondly, during test for linear correlation loss of constructs came about in order to avoid the potential spurious relation between some of them (i.e. multicolinearity) as the model had to be corrected for autocorrelation and heterocedasticity.

TABLE 4: EMPIRICAL DETERMINANTS OF FDI DECISIONS, 1987-2001

	?	StdErr?	BETA	T	SIG T
CONSTANT	4418.135	19832.36	.	.22277399	.82393322
OWNED	137.505	300.87	.03227802	.45702423	.64813755
RIGHTS	-294.005	932.77	-.02216884	-.31519521	.75293405
OPEN	-75.885	436.02	-.01291489	-.17403966	.86200604
DAYSPPPP	-54.126	1056.63	-.00479663	-.05122541	.95919578
DAYS%	-4.421	19.75	-.01623660	-.22378139	.82315027
RISGOPAI	-293.868	2151.01	-.02077565	-.13661881	.89146618
PIBH	-6.689	103.44	-.00498485	-.06466764	.94850164
RCESI	38073.833	93269.83	.09607532	.40821166	.68354434
FDICS	-166.499	365.89	-.06921418	-.45505069	.64955432
ONE1	381.693	1161.01	.14749937	.32875920	.74267330
CORRUP	-24657.487	134247.38	-.12152685	-.18367202	.85445230
K2GNP	-2421.748	6122.22	-.48474691	-.39556713	.69283573
UNION	570.710	5187.96	.05773222	.11000653	.91251181
LFORCE	450.356	6655.86	.02145275	.06766317	.94611971
PDI	-952.532	2279.18	-.15970505	-.41792735	.67643766
INDI	-1633.970	5654.55	-.31253281	-.28896544	.77289983
MASI	-875.181	5018.73	-.22489815	-.17438289	.86173665
UAI	101.753	6859.41	.00486794	.01483412	.98817894
FINANCIE	115.939	228.17	.03985025	.50812524	.61191183
BIG4	848.801	2292.45	.27620793	.37026002	.71157103

```
Multiple R              .17452872        Standard Error         1294.6866
R-Squared               .03046027        Durbin-Watson          1.9904282
Adjusted R-Squared      -.06885843       Rho                     .11985715
                                         Standard Error of Rho  .06917104
```

As a result of the careful screening, five constructs (25%) provided details as to the financial characteristics of the transactions (s^n). There were three constructs (15%) dealing with terms of trade and degree of openness were identified as potential measures of market size (M_{ij}). Three constructs (15%) considered relative income measures and an index for the intensity of union militancy throughout the work force and were identified as potential measures wage effects (W_{ij}). There were three constructs (15%) to represent the market for corporate control and four (20%) national culture. Three constructs (15%) considered trends and directions of M&A activity ($?_{i-1}$). One instrumental variable (5%) was added to identify transactions involving the most active companies (financials) as described in Table 1 and Fig. 3 ($?_1$). A second instrumental variable (5%) identified the main recipients of Spanish FDI in terms of number of transactions as described in Fig. 2 ($?_2$).

Conclusion

Statistical analysis of M&A activity suggested most transactions were concentrated in a handful of countries and led by a few firms. Hence we found that during the 1990s, Mexico, Brazil and Argentina were, in general, the countries which received most Spanish FDI. Related to sector distribution, Electric, gas and sanitary services (49) and Communications (48) took the second and third places in terms of M&A activity while the most active sector was Depository Institutions (60). The importance of the financial sector was based on the strong development in Latin America of the main Spanish banks: SCH and BBVA.

The prominence of the corruption index (CORRUP) as well as number of days to finalise the transaction (DAYSPPPP and DAYS%) suggested MNCs were happy to accommodate the institutional environment provided there was certainty their rights would be protected. Corruption impinges designing solutions on a case by case basis both when selecting the target and to implement systems of information and control. It would thus be very hard to run international operations if each and every time local managers were to devise unique solutions. The propensity for unions to influence negotiations (UNION and LFORCE) had a positive effect on the value. At the same time, the development of the stock market seemed important (K2GNP and OPEN) as a mechanism to clear transactions rather than to help finance the deal. Of course the larger the size of the local companies the less likely to find suitable candidates (i.e. negative sign of K2GNP). This would be consistent with the idea that possibilities to exploit market-value differences emerge as in less developed countries (Hu, 1995, 84-5; Porter, 1987, 49 and 52).

Given that most trend variables were discarded while market and wage effects remain (including instrumental variables for the four biggest economies), suggesting that buying into the right market was more important than acquiring the right target. This result was consistent with poorly developed financial markets and a strong preference of Spanish MNCs to acquire control (i.e. average ownership after transaction equal to 67%). However, the nature and intent behind this acquisitions is still a topic that requires attention.

Appendix 1: Diversification of Spanish MNC by Industrial Sector

TABLE A.- SECTORS WITHOUT CROSS-BORDER ACTIVITY

SIC Code	1987 U.S. SIC Description
2	Agricultural production- livestock
7	Agricultural services
8	Forestry
9	Fishing, hunting, and trapping
12	Coal mining
14	Nonmetallic minerals, except fuels
23	Apparel and other textile products

30	Rubber and miscellaneous plastics products
31	Leather and leather products
43	Postal Service
46	Pipelines, except natural gas
52	Building materials, hardware, garden supply, & mobile
53	General merchandise stores
54	Food stores
56	Apparel and accessory stores
64	Insurance agents, brokers, and service
72	Personal services
75	Automotive repair, services, and parking
79	Amusement and recreational services
81	Legal services
82	Educational services
83	Social services
84	Museums, art galleries, botanical & zoological garden
86	Membership organizations
88	Private households
89	Miscellaneous services
91	Executive, legislative, and general government
92	Justice, public order, and safety
93	Finance, taxation, and monetary policy
94	Administration of human resources
96	Administration of economic programs

TABLE B. -

SECTORS WHERE TARGET OR ACQUIRER IS ACTIVE BUT NEITHER IS STATISTICALLY SIGNIFICANT

		Target (Lat Am)		**Acquirer (Spain)**	
SIC Code	**1987 U.S. SIC Description**	**Value of Indicator, A_{pq}**	**Nº of transactions**	**Value of Indicator, A_{pq}**	**Nº of transactions**
10	Metal mining	6	1	0	
24	Lumber and wood products	6	1	0	
26	Paper and allied products	6	1	0	
34	Fabricated metal products	0		41	1
41	Local and interurban passenger transit	0		55	1
42	Motor freight transportation and warehousing	44	2	0	
51	Wholesale trade--nondurable goods	5	1	0	
55	Automotive dealers and gasoline service stations	60	3	0	
57	Furniture, home furnishings and equipment stores	5	1	0	
58	Eating and drinking places	0		47	1
59	Miscellaneous retail	16	3	0	
61	Nondepository credit institutions	4	2	0	
67	Holding and other investment offices	11	13	40	51
78	Motion pictures	10	1	0	
Sum			*29*		*54*

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End Notes

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[1] Defined as assets or capabilities that need to be build up or acquired in the target country in order to fully exploit the firm's advantages in that country.

[2] http://www.unctad.org/en/subsites/dite/FDIstats_files/FDIstats.htm

[3] Target or Acquiror Nation : Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cuba, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay and Venezuela.

[4] A caveat similar to other assessment of companies' data with a sector breakdown, is that service sector might be under-recorded because companies are classified according to their main line of activity. For instance, companies such as IBM generated over 40% of income from services in 2001 yet the parent-company's main line of activities was classified under hardware manufacturing. This bias against service industries is, perhaps, mitigated by the fact that industry classification of the deal refers to the unit whose ownership has been transferred rather than to the whole group (i.e. the parent company).

[5] Country classification of the deal refers to the nation state of the unit whose ownership has been transferred and the unit who has acquired rather than the whole group (i.e. the parent company).

[6] Target or Acquiror Nation : Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cuba, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay and Venezuela.

[7] Art. 4.1., Real Decreto 672/1992, 2nd July, considers Spanish foreign investments and establishes that "it's presumed that effective influence exists in a foreign firm management when the investor's participation, direct or indirect, is equal or superior to 10% of the social capital".

[8] Note that using the average number of transactions to calculate the theoretical flow (T_{pq}) was equally problematic given the cyclical nature of both M&A and FDI decisions (phenomena which is well documented).

[9] For 30 d.f. or more the chi-squared statistic is considered to distribute as a normal with mean 1 and variance 0. An approximation to 45 d.f resulted from adding the values for the chi-squared with 15 d.f. (25) to that with 30 d.f. (43.77) for a 5% level of significance.

[10] Not shown for brevity but available from the corresponding author.

Subordination and Creativity in the World Economy

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Abstract

This paper describes the relation of forces that govern the international economic order and suggests how it can be altered in order to make it possible for countries in the periphery to neutralize the weight of technological subordination and advance on the path of development. However, the struggle against economic dependence is just one aspect in the development process. True deve lopment does not exist without first liberating the creative capacity of the people in the developing economies of the periphery.

Historical Antecedents

Comprehending the problems faced today by the developing economies requires an historical and structural view of industrial capitalism. The wealth accumulation that is responsible for its generation was preceded by an increase of the commercial surplus. The discovery of the maritime route to India by the Portuguese at the end of the 15th century was based on considerable investment of science and navigation techniques, naval construction, cartography work, and training of highly skilled personnel. More than a century of consciously planned actions separate the first exploratory maritime expeditions in the African coast from the arrival of Vasco da Gama to India.

Once the trade route was inaugurated, the reduction in transportation costs and the elimination of a whole chain of intermediaries brought considerable profits to the Portuguese. The opening of the commercial lines of planetary amplitude in the first half of the 16th century is at the root of the accumulation process that would lead to the industrial revolution. The observation of this period, during which the industrial civilization was being generated, is the key to comprehending the most characteristic features of the capitalist societies of our days.

The rich markets of Southeast Asia that were initially pillaged, the formidable reservoir of labor discovered in Africa and the Americas, and the reserves of precious metals of the latter increased enormously the base of European economy for its capacity of generating the surplus. During this phase of the economical evolution of Europe, there is considerable increase in the surplus without a corresponding change in the productive forces. In the regions they “discovered”, the Europeans exacted a surplus by authoritarian means in addition to the profit resulting from commercial operations. The conquest of the Aztec and Inca empires, among many other conquests, brought them substantial wealth in the form of precious metals while the production organization was based on slavery. The native populations of the Americas and the millions of Africans transplanted to the New Continent against their will paid the highest tribute in the phase of European accumulation of wealth.

The subsequent transformation in the system of social domination-the bourgeois revolution-constitutes the decisive step in the formation of the capitalist societies of our days. A consequence of the industrial revolution, the bourgeois revolution represents the triumph of the bourgeoisie over the agrarian aristocracy and the consolidation of the capitalists and proletarians as social units.

The industrial revolution and the advance of capitalism first happened in the European regions where the ascension of the bourgeoisie, based on the expansion of the surplus of mercantile origin, was facilitated by its cooperation with traditional dominant groups. Trading companies with great powers delegated by the states appeared in England and The Netherlands at the beginning of the 17th century. These companies made possible the direct cooperation of kings and the aristocracy in general with the merchants in their lucrative overseas operations.

From powerful financial positions that it was consolidating, the bourgeoisie reached the decision centers and obtained (or imposed) institutional changes like the free initiative, free contracting, free circulation of goods, etc., that were extended to new areas of social life. Thus, the medieval guild system, with its cramping restrictions on trade and industry was gradually dismantled, while the rigid control of the rural population by the landed oligarchy was totally abolished. It was the subordination of the production activities to the logic of the market that led to the industrial revolution. In the society that emerged from this transformation, the economic activities assumed considerable autonomy and acquired an important role in all dimensions of culture. To accumulate, to increase the surplus became objectives by themselves. The elimination of all obstacles to productive efficiency was considered “rational” (Gehlen, 1989). The industrial revolution results in the establishment of a new social order in which not only the physical power but also the intellectual capacity of human beings is increasingly subordinated to market criteria (Habermas, 2003). The last quarter of the 18th century and the first half of the 19th century can be viewed as a transition between the startup of the new social order and the industrial capitalist society. In the latter, the accumulation process is incorporated into the production organization and external relations are auxiliary lines that add flexibility to the whole system. Increasing the surplus does not depend any more on the opening of new commercial routes. The surplus can now be increased by increasing production efficiency. The innovation of production methods is now the shortest path to surprising competitors and therefore becomes an instrument of power.

The Diffusion of the Industrial Revolution

After its beginning in England, the diffusion of the industrial revolution was a comparatively slow process, with France and later Germany (mid 19th century) joining its process. Other European countries, with the exception of Belgium, did not keep pace with France and Germany. Italy became partially industrialized late in the 19th century. Spain, Portugal, Russia and the Balkan countries remained relatively untouched by the great drive toward industrialization, though some advances were made in each country. Russia was modernized in the 20th century, under the communist revolution.

Of the non-European countries, the United States and Japan took full advantage of industrialization. By the middle of the 19th century, American-made machines began to be imported into Europe. Agrarianism persisted in Asia, Africa and Latin America until the 20th century. The transference of labor from activities of self-subsistence to coffee, cocoa, rubber, and sugar cane plantations give origin to a purchasing power in the international market, through which certain populations in those agrarian areas started having indirect access to the benefits of technical progress. Through indirect means, consumption is diversified without any significant evolution in the productive techniques of those underdeveloped areas.

The ideological values that appeared with the bourgeois revolution-liberalism, individualism, rationalism-that were used as levers to displace the old domination structure and promote the ascension of the social agents committed to the accumulation, when transplanted to the developing nations, were the same values that served to reinforce the state of dependence.

The industrialization of the economies that had access to the industrial civilization through indirect means manifests itself as an evolution of their international relations. Industrialization happens as an answer to tensions in international relations caused by problems with the trade balance of those countries. When the ability to import is contracted, these economies will start industrial activities complementary to their import activities. Therefore they go from importing the fabric to importing the thread, from importing the car to importing its parts and “nationalizing” its final assembly, and so on. When later on, the local industry is called to generate part of the payments in the exterior (without which its growth cannot materialize), access to external markets poses limits to internal industrialization. This process reinforces the position of the transnational companies.

In the framework of dependent industrialization, the determinant of the technology utilized is the degree of diversification of demand (the nature of final products) generated by the social groups that had indirect access to the industrial civilization. The industrialization process in these developing countries will assume the form of an adaptation effort of the productive systems of those countries to this sophisticated demand. A productive system of high capital density and low capacity for generating employment was thus created that does not correspond to the level of accumulation of the whole developing society. Since this subsystem is structurally linked to the advanced economies, the dependence continues to exist.

The increasing infiltration of rationality criteria into the social body would ended up producing in Europe a civilization style with the following characteristics: Industrialization, i.e., the technical nature of all productive activities; urbanization, i.e., spatial structuring of the population to satisfy the demands of the labor market , and secularization, i.e., prevalence of reason in the legitimization of power systems. The rapid process of accumulation and technological advancement that are inherent to the industrial civilization enabled certain European nations and later the United States, to control the quasi totality of the planet. Modern history and the history of our days is in great part a reflex of this enterprise of planetary domination and the resulting effort on the part of the dominated peoples of the Third World to liberate themselves. The next section deals with some of the possibilities opened to the developing countries to alter the balance of forces that seems to perpetuate the subordination of most of the world nations to a small group of countries that were favored by the industrial revolution.

The Resources of Power

The large enterprise that alone or in the framework of an oligopoly is the one that administers prices, conditions the habits of consumers, and modifies the markets through credit, thereby exerting unequivocally ample power. In its transactions with the exterior, the large enterprise is simultaneously representing its own interests and also the interests of the economic system in which it resides. The situation is different when the same enterprise is implanted in more than one economic system. In this case, it has at its disposal resources of power that can liberate it from the constraining action exerted by the national centers.

The large enterprise is an entity of social relations, hierarchically organized, that serves a programmed will in order to condition the behavior of chosen segments of society. It is at the international level that the innovative capacity of industrial capitalism is the most fecund. The expansion of the large enterprise overseas is the most complex when the industrial activity is decentralized geographically, where the units located in several countries specialize in one or more processes that are part of the same productive activity. The labor-intensive processes are located in those countries where there is easy access to cheap labor, the assembly processes are located near the consumer market, the polluting processes in places where the environmental legislation is less restrictive, etc. This type of business structure is called *transnational*. The struggle against dependence will happen with more intensity in the framework of international business and transnational companies. If one assumes that for a developing country isolationism is not an option, the strategic objective is to minimize the cost of dependence and to explore paths that would lead to substituting dependence for interdependence. What are then the real resources of power that would enable the peripheral countries to modify the present configuration of forces in the international market?

Among the resources of power that are the base of the present international economic order, the following are particularly relevant: (1) Control of technology, (2) control of finances, (3) control of access to internal markets, (4) control of access to non-renewable resources, and (5) control of access to cheap labor. These resources, in significant amounts, and/or combined in various proportions, create positions of power occupied by states or important economic groups in the struggle for appropriating the surplus generated by the international economy. Coalitions of peripheral countries allow them to obtain initially the critical mass required to control one resource or to articulate combinations of resources of high effectiveness in creating positions of power. Let us review one by one, all the mentioned resources of power.

Control of Technology

The struggle against dependence is the effort to neutralize the effects of the monopoly of technology in hands of the developed countries. Technology has the property of substituting other resources of power. In the industrial civilization, technology is the final expression of human creativity. The industrial civilization is the resultant of certain orientation of human creativity that favors accumulation and leads to the reinforcement of certain social structures. The product of creativity is modern technology, the basic ingredient of the accumulation process. To confront these positions of power by using adequate combinations of other resources, or the critical mass of some of them, is the essence of the struggle against dependence. Technological domination tends to deepen as the network of interests of the transnational enterprises becomes denser. Ultimately, these companies control the diffusion of technology around the globe. The cession of technology through licensing contracts has no interest to the firm that can explore directly this technology, using it to form the capital of subsidiaries, to amass local financial resources and enlarge its scope. This is the reason why instead of forming a "technology market" at the international level, during the industrialization phase of the developing countries, the area of transference of these leading edge technologies was limited to transactions between groups that could insure each other adequate compensation in terms of technology.

Control of Finances

With regard to financial resources, the changes that occurred in the last decades are considerable. On one hand, development of banking networks and direct action of the state are channeling large sums of money. On the other, the direct access to international financial markets has allowed many developing countries to maneuver with a degree of freedom, unknown in the times of the rigid control exerted by the International Monetary Fund. It has become evident that transnational enterprises installed themselves in developing countries with resources that are in great part raised locally (profits from trade operations, association with local groups, government subsidies, etc.) and with resources from international financial markets that usually have a return on investment guaranteed by the local monetary authorities. The large investments in infrastructure that make possible the implementation of subsidiaries of transnational enterprises are financed with compulsory local savings and external resources guaranteed by the state. Summing up, there is a pool of financial resources that can be utilized by the states, this way increasing their leverage in international relations. After 1973, the emergence of a considerable surplus in the trade balance of a small group of oil exporting countries is another important event in the pursuit of financial power. For the first time it became feasible to start important projects of common interest to peripheral countries without the sponsorship of developed countries or international financial institutions controlled by those countries. The periphery was transformed into an important player of the international financial markets.

Control of Access to Internal Markets

Here is another source of power in international relations**.** Trade barriers have been used as defensive or offensive weapons in confrontation of external interests. In the present phase of the rush of the transnational enterprises to control positions all over the planet, access to internal markets has become crucial. This is easier for those transnational companies that already have a commercialization network, that control a segment of the market through imports, and have connections with local financial systems. Given the small investment required for installing a subsidiary in a peripheral country, barriers to entry of transnational in these countries are minimal. Consequently, the market forms that emerge are similar to what is called "monopolistic competition" in economic theory, much different from the oligopolistic forms that prevail in the developed countries. This situation requires the states to exert tighter control of these enterprises and, in certain cases, to demand participation in their direction.

The relatively limited internal market of many developing countries has lead them to join together with other countries into "free trade zones," "common markets," and other similar schemes , all aiming at augmenting the space within which the enterprises organize their activities. The necessity of coordinating local policies in the face of transnationals has become more urgent, if one wishes to avoid that these enterprises take advantage of possible rivalries between countries regarding the location of economic activities. The articulation of economic policies and the joint financing of projects of common interest strengthen the position of the smaller states in their dealings with transnationals.

The basic policy that emerged aiming at preserving control of internal markets in the face of offensive strategies by transnationals was to limit the time of control of a market segment by a transnational. Control is inevitable in a first phase, given the difficulties of accessing the necessary technology. The contract to explore a segment of the market for an indefinite period of time is thus replaced by a contract for a limited period of time. The control by the enterprise of its production, marketing, and finance departments (not only the stocks) should be gradually transferred to decision centers in the host country. Financial resources cannot be raised in the internal financial market unless this condition is fulfilled. The objective is to have the transnational to be a part of the local economic system (regional in the case of a coalition of countries). If local control is extended to other sectors, a critical mass is formed that enables the states or internal groups to put pressure on transnationals to make their technologies available in less onerous terms. The larger the internal market, the easier is to reach a positive outcome. In the case of small countries, the coalition is a *sine qua non* precondition for this policy to succeed.

Control of Access to Nonrenewable Resources

This type of control has always been considered one of the principal sources of power in international relations. The logic of the accumulation system, with its short time horizon, tends to put an increasing pressure on the so-called nonrenewable resources. In developed countries, powerful interests try to create the illusion that exhaustion of those resources will never happen because technology by itself will be able to solve all the problems that it creates. Developed countries continue to explore their own reserves within private criteria that reflect the short time horizons already mentioned. Therefore, barriers are created that impede the organization of the global supply of those resources. The elevation of relative prices of most of the nonrenewable resources is a necessary condition for reducing the present waste of these resources and for reorienting the technology in order to gradually save those resources. The policy adopted by certain developed countries with respect to their own resources is going to help the peripheral countries in the medium and long range. Coalitions of developing countries will be the most effective means for exerting control over their own resources of nonrenewables. To this effect, the ability to control the local financial markets is also crucial as explained before.

Control of Access to Cheap Labor

The vast reservoir of cheap labor that exists in many peripheral countries have been a source of weakness in their international relations with countries of the center. Cheap labor is responsible for the low prices of many agricultural products exported by the developing countries. Organizing the supply of these products was the first step in the struggle against dependence. Cheap labor also appears in the form of manufactured products produced by subsidiaries of transnationals in strategic locations of the developing countries. Presently, all the countries that have abundant cheap labor are willing to make their labor supply available to transnationals under the most favorable conditions. The only obstacle to expansion of transnationals in this direction is posed by the developed countries themselves, preoccupied with the direct and indirect effects upon their economies of exporting their jobs by the transnationals. If this trend continues and cheap labor remains important to the transnationals, the former weakness of cheap labor can be transformed into a new resource of power. Even a substantial increase in the price of this labor will not make it too expensive when compared to the alternative of the developed countries where salaries are five to ten times higher for identical work. The countries that have cheap labor can introduce a tax in the exports of manufactured goods using that labor, in order to cover (at least partially) the differential between their wage rates and those of other peripheral countries competing in the same market. In the present situation, the transnationals can choose from among several countries and therefore exert pressure on each one of them.

Where to Start?

The resources of power should not be considered in the same level. In different degrees, all of them have been used by many developing countries. But only recently they have been used in an articulated form with the explicit objective of changing the order of international relations so as to benefit the countries of the dependent economy. Since technology is the only resource that can substitute for the others and is the one monopolized by the developed countries, it is correct to say that dependence is first technological. To gather the other resources of power to neutralize the weight of technological dependence is, therefore, the goal of the developing nations in their advance through the path of development. The struggle against dependence starts by regaining control of their own sources of nonrenewables. This is followed by occupying positions that enable the developing countries to control access to internal markets. From the success obtained in these two fronts, a critical mass of financial resources could be achieved that would allow the consolidation of the positions conquered and to increase the area of action. The struggle in the technological front is only feasible when important segments of the international market have been secured and achieved a critical mass of financial resources. In all phases of the struggle, coalitions of developing countries are essential.

Conclusion

The doctrine of international specialization was presented to the developing countries as the shortest path leading to the enrichment of a region or country. According to this doctrine, the country should place itself in the system of international division of labor and specialize in producing one or a few agricultural products. The delay in the diversification of consumption would be eliminated and the country could then advance to the front line of the civilized nations. Later, after the collapse of the exporting model of primary products, a new pact between external interest groups and internal agents on which dependent industrialization is based would substitute the idea of development for the myth of international specialization. Gradually deprived of historic memory and sense of identity, and gauged by a measurement system conceived with the objective of accumulation, the developing countries were classified, ranked and labeled as abstract entities whose behavior is tentatively explained, based on limited and inadequate data. Since development is equated to *international performance*, totally ignoring the cost of accumulation in terms of cultural values, the history of the developing countries is seen as a competition where the award is to be increasingly like the countries that lead the accumulation process. The idea of development as international performance is detached from the social structures since it is the result of a pact between some internal and external groups interested in accelerating the accumulation process. The most fundamental impulses of human beings, generated from the need of self-identification and locating themselves in the universe-impulses that are the matrix of creative activities such as philosophical reflection, mystic meditation, artistic invention and scientific research- one way or the other were all subordinated to the process of transformation of the physical world required by accumulation. The limits of creativity to human life conceived as an end unto itself were atrophied while its links with the tools used by human beings to transform the world were hypertrophied. Marcuse illuminated an important aspect of this discussion by arguing that because of its own methodology and concepts, science projected and promoted a universe where the domination of nature remained linked to the domination of human beings (Marcuse, 1992). In a capitalist economy, accumulation marches on two feet: <u>Innovation</u> that allows discrimination between consumers, and <u>diffusion</u> that leads to the homogenization of certain forms of consumption. The consumer has a passive role. Its rationality consists in responding correctly to each stimulus. Innovation always points to a higher level of expenditure that is the distinctive mark of the privileged consumer. But what is standard will have to be superseded and diffused so that the market can grow in all its dimensions. Creativity is then conditioned by the laws of this growth. The struggle against dependence is just an aspect of the development process. This will not materialize without first liberating the creative capacity of the peoples in developing nations. The most negative aspect of control of productive systems in the developing countries by transnationals is the transformation of the ruling elite of those countries into simple transmission belts of cultural values generated in the developed countries. The dependent nation looses the capacity of conceiving its own objectives. This is the reason why political authoritarianism fits dependence very nicely. Economic dependence, cultural control and political authoritarianism complement each other and reinforce one another.

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Section 2
Country and Sector Studies

Main Inadequacies in Strategic Planning Process in Jalisco: Case Studies

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Abstract

For many managers the challenges of the competitiveness, the globalization, the new technologies and the uncertain development of the markets take them to doubt on the future and if they will be able to coexist in that atmosphere or they will simply disappear. Strategic Planning Process and their coherence with the focus and administrative system that one has, they are a key factor to face these challenges. The results that we are presented is a synthesis of the research carried out in 60 companies of Jalisco's State, directed to identify, to describe and to value the processes of strategic planning and their coherence with the processes of: formalization, leadership, organizational culture, motivation and the workers' implication. The research one, carries out in three stages among the months of December 2001 to august 2002, in the same one, 60 students at Universidad de Guadalajara in MBA's major were collaborating The approached problem was that of the inadequacies that present the strategic planning processes and its lack of coherence to give answers to the new conditions of competitiveness. Besides the general research methods, the techniques of documental research were used, surveys, interviews and in accordance with the possibilities and specificities of each company another group of techniques to value the processes of administration. A Diagnose Guide in the one that 95 main categories of the investigated processes were valued they facilitated their prosecution and presentation in charts. In the work, the results are presented obtained in the 95 elements investigated in the 60 companies, contained by four aspects:

1. **Backgrounds and Profile**
2. **Organization and Culture.**
3. **Strategic Planning.**
4. **Human Resources.**

This information is accompanied of an analysis of the results in accordance to: the company size, type of property and administrative styles used. It is included the conclusions with the main inadequacies. A summary of the main SWOT results is also included carried out by each company, where the highest frequencies in coincidence are pointed out, of the weaknesses, opportunities, strengths and threats that perceive the same ones in common way.

1. Introduction.

The world in that we live is a world in crisis, but crisis in the sense of moments of big changes in the humanity's development, important qualitative and quantitative jumps that will open the way to a new era, to a revolution of the productive forces and big changes in the production relationships.

For such a reason the processes of managerial administration in the current world are characterized by a great uncertainty, a high risk and an insecurity of how to proceed before the group of threats and difficulties that should face in the business. This uncertainty is even bigger in the countries in development, increased by multiple factors that influence in the same ones

In turn they should be coherent to each other and in consequence they impact and they change the whole system of productive and not productive relationships that they conform the base of the society.

The formation and structuring of the new technological system

To move strategically we have to understand in all their reach the development of the new technologies and to establish their influence in the branch in which our company is unwrapped and starting from this which there is possibilities to have competitive advantages, because periods of time can maintain those advantages which we have to change.

Not all the tendencies in the formation of the new technological system are clear, the necessity of coherence will give origin to other big groups of technologies that contribute to form the net or mesh technology of the Third Industrial Revolution.

A very important phase of the development of the new technological system constitutes it its structuring. The same one consists on the establishment of new relationships between those technologies and the application until obtaining products and processes of extensive use. In this phase the conditions are believed you stop the disappearance on behalf of the old technologies, the regeneration of another part and the emergence of other new ones. The characterization of the new system can be analyzed through the following processes:

?? The formation of technological meshes.
?? The new group logic.
?? The social changes.

It is on this part of the development of the new systems, where the strategic planning of the company and their interrelation with other key process of the administration, it should deepen but to reveal their futures markets and the distinctive advantages that one will be able to use to win in the fight for the competitiveness.

The social changes

It is the most complex in all the process of the structuring of the new system, because in him the new lists that played the men and their organizations intervenes. The first great consequence of these crises is the imp act of the new technologies in all the productive processes and of services presenting a quick change in the productive technologies, the second consequence is the globalization of the production and of the trade, the third are never before the growth of the fights of the competitive forces in levels, methods and reach seen, the fourth is the meaning and importance that the average man acquires as client, as worker, like object and subject of the managerial processes in interrelation like I hold and object of the conduction of all the social processes, the fifth is the growing abyss among the rich and poor countries, Latin America increased to 40% its population mass in serious poverty.

The changes in the forms of administering

The forms of administering traditional that characterized to the second industrial revolution they are disappearing quickly and giving space to a new form of administering. that gives priority to the strategic thing on the operational thing in a dialectical application that integrates both in a development in hairspring. This change gives a new dimension to the forms of administering. We will call it Strategic Administration to mean the integration of the strategic thing and the operational thing in a constant replanteamiento. Three pillars of this new conception under the conditions of Mexico will be to understand, the strategic thought, the leadership transformational and a coherent organizational culture.

The new form of administering does not arise overnight, neither it is manifested in all its magnitude and integrity in some few months, with the result that the leader aware of those deep changes, begins a process but or less slow according to the conditions of her company and to the possibilities of the personally, her community and the environment.

In that beginning process, the development of the strategic thought and the materialization of a process of strategic planning believe the favorable conditions to reveal the needs of a change that it integrates all the signal elements and that it allows him to compete in the new mark of globalization of the economy..

The economic development of Jalisco in its beginnings was eminently agricultural and it served as base for the development of an autochthonous capital that moved fundamentally to the cities in the trade sector, giving origin to a tendency toward the small and medium companies in that sector that taking advantage it magnifies geographical position in the center of the country, it served as channel of the trade toward the north and the center of the country. The derived industry of the agriculture, mainly the tequila, the lumberman and the footwear, they were also important rubles, together with the craft. Reaching to be the third economy of the country, after the Federal District and the State of Mexico.

2. Possible Scenes

The interpretation of the pointed out documents can give origin to multiple interpretations, all them polemic. Where surely all or most would coincide, it is that the same ones were carried out in a much more promising context that the current one, from an economic point of view.

Later events as the events of September 11 and the war of Iraq, as well as the own mark of current address of the United States that is the ship badge of the world economy in these moments, is pointing toward a much slower recovery of what was expected, factors of strategic character and of national security, they are slowing and committing the dynamics of the North American economy and increasing the problems of the economies of the South Cone, that that together to a devaluation of its currencies and to the entrance in the NAFTA, that that together to multiple collateral factors, they point out that the possibilities of competitiveness of many producing of Jalis co are more complex, that which forces us to a much more visionary, scientific strategic projection and transforming.

You threaten and limitations

The agriculture faces big derived dangers of the entrance in vigor of different paragraphs of the TLC. That it places in evident competitive disadvantages to the sector, especially in poultry, bovine products and their derived, as well as in grains and forage.

In the last two years it is noticed in the industry assembly plant a decrease, for the triple action: of the step of some productions to the automation and being assimilated in the countries of the main houses; for the displacement of the investors toward other regions of Latin America with less problems in the movement of the generated capital and in the union actions and of labor regulations and the growing increase of the cost of the manpower and other expenses of the companies, in comparison with Asian regions or of Center America.

Another threatening factor is manifested in the industry of the footwear and of the piece of furniture, with the entrance of China and other countries of the Southeastern Asian countries with very competitive prices

The small and medium company also faces an accumulation of contracted debts when the lost ones derived of the devaluation of the weight in 1994 and that at least it could face the interest payments with the growth had up to the 2000, but after the process of paralyzation of the economic development in the last two years, this situation believes very difficult conditions for the companies that suffer them. The foreign investments in the country have a decrecimiento, what can stay for such negative factors as: the fear that the economic processes in Argentina, Uruguay, Brazil and Venezuela know they make worse and affect to the whole region.

The advantages in wages and deregulations in the systems of labor protection in other countries of Central America and Asia that with the extension of the NAFTA, they allow displacements to Center and North American and European and Asian investors' South America and from those countries to compete but advantageously. The educational level is a factor that has favored as competitive advantage in the past to the region, but of not being assisted, it can become a threat to medium and I release term, because the covering of alone 91.4 percent in primary and a 86.8 in secondary, with efficiencies of 85.5 and 69.8 respectively that they were had and the proportion of 11.8 of university population in older than 18 years. They are insufficient for the objectives of competitiveness that you/they love each other to reach. To these elements they sink others that we will analyze but ahead.

Another element that becomes a potential threat is the potentialities and participation in the investigations, evidently the possibilities that he/she has the region are very superior to those that are in march and they don't give answer to all the necessities of the managerial sector. Later on we will see other elements that point out but limitations in this field delay sciences and the techniques.

Most of the local sectors of the industry, the trade and the services have not been able to carry out capital investments that allow them to be modernized and to be developed successfully in an environment of growing international competition.. Presenting problems of competitiveness.

A broken into fragments productive structure subsists in Jalisco, defined by a managerial culture that is characterized by an attitude and not very aggressive acting as for its competitive participation in the open market.

Companies with little opening to the asociacionismo and with companies that you/they have not been able to be modernized due to low investment flows and to the limited access to the financing.

The limitations that present the micro and small companies to incorporate innovation strategies and technological development, their restricted negotiation power, the access difficulty to competitive financing, their reduced diversification of markets, the expensive regulation that affects their operations and the lack of appropriate fiscal treatment, among other factors, they affect the competitiveness of the same ones.

The integration of the chains of value constitutes perhaps, the main limitation of the composition of the economic base of Jalisco, in that sense had special attention the association of the small and medium agricultural producers in the chain of value of its products.

The disloyal competition that the officially constituted companies, they suffer on the part of the submerged economy. All the factors before mentioned, they give as a result that the competitiveness of the companies of Jalisco can it turns seriously affected in a future, the analyses of the productivity for nations, dice to know to the beginning of the 2003, point out a setback of Mexico of the position 40 to the position 45.

3. General Considerations on the Investigation

The purposes in this investigation of university character, it is the relevancy sense that you/they should have the investigations carried out by the professors and students of these institutions and that they should try to contribute to solve the urgent problems of the country and the region to that you/they belong. In this sense we have identified that in the current moments the companies of Jalisco face circumstances very different to other historical moments of their development. Those circumstances require adjustments and changes in many of those companies to face the new challenges and next we expose some of the results obtained in the first part of the investigation process carried out in 59 companies of Jalisco, about the main inadequacies in the processes of strategic planning and their interrelation with the organization and the existent leadership.

Process of investigation

The process of strategic planning is a very wide and complex topic in the one which the dynamics of its development, the limitations that the actors of the study object impose (The Company); the impossibility of controlling the extrinsic variables, the quantity of independent variables and clerks and another great number of factors conditions the possibilities of experimental, random investigations and with a certain grade of dependability, for what we design for this first stage a fundamentally qualitative investigation, of exploratory and descriptive character that using the trial of experts, they combined different methods and techniques to describe and in an approximate way to estimate the grade of behavior of the most significant variables in the processes of strategic planning. And of their interrelations with the organization, culture and leadership.

As all exploratory investigation he/she doesn't have a final conclusion and therefore they are informative elements to clear incognito and to present tendencies that logically can be accepted or not for the in agreement specialists with their attachment to the investigation focuses Positivistic or Hermeneutic that the same ones profess.

The approached Problem was that of the inadequacies that you/they present the process of strategic planning and you outlines as: Which is the grade of application of the Process of Strategic Planning in the companies of Jalisco in correspondence with its integration to some main components of the Strategic Administration?

The general objective was: To describe the grade of realization of the processes of strategic planning in the companies of Jalisco in correspondence with their necessity of coherence with the processes of strategic administration of the same one and the demands of the environment.

One of the specific objectives was the one of to identify which was: the one Diagnoses Strategic of each one of the companies by means of the identification of their main Strengths, opportunities, weaknesses and threats and their agreement valuation the development grade and coherence that I know observed in the process of strategic planning.

The investigation process was designed assisting to the limitations that are presented in this study object, like an exploratory investigation that used the general methods of the observation, induction, deduction, analysis and synthesis, in which they collaborated but of 70 students of the last semesters of the Master in Administration, with the due theoretical preparation and one practices in the processes of strategic administration, those that besides the general methods of investigation, they used the techniques of documental investigation, surveys, interviews and in accordance with the possibilities and specificities of each company another group of techniques to value processes of strategic administration. The investigation was made as general tendency in companies that the students worked and that they knew their processes, including the administration processes.

When outlining the investigation, we find the difficulty that most of the companies didn't authorize to that the identification of the same ones appeared in publications, to contain information that could be used by the competition among other reasons, of equal it forms the content in detail of the processes that they carried out.

Data reception and processing

Next we will present the results of summarizing the four components of the main SWOT carried out by the 54 companies about the main strengths, opportunities, weaknesses and threats that face the same ones. , as well as the summary of the valuations that the 70 students of the results made obtained in the I Diagnose of the situation in the investigated companies .

4. SWOT Analysis in the Companies.

In each one of the investigated companies they were asked them to carry out an exercise of determination at least of: the strengths, opportunities, weaknesses and threats that the leaders identify for the development of the same one.. Its realization of being possible would be made with the main actors of the strategic projection of the same one and in the face of the impossibility of executing it in that form that was carried out for the investigator on the base of the opinion interviewed with the executives, the results of the whole process of the diagnose and the investigator's own conclusions.

The main SWOT can be a very useful element, when to specify which is internally the real state of the organization and in connection with the environment. It is a diagnosis of each company and it is not possible to extrapolate to other companies. The result should be expressed in the identification of the five factors that more it influenced in each analyzed quadrant.

We carry out a classification all the factors identified in the 54 companies that you/they carried out the analysis and envelope the coincidence base in the fundamental and alone writing differences they decreased the same ones. Next they left writing down the identification of the factor for each company in the listing. Next we present the obtained results, in what the factors are included that you/they were identified among the five main in at least 20% of the companies.

Strengths

After the reduction they were 20 factors like strengths

	Companies’	%
?? Image of grateful mark and appreciated by the clients	26	48
?? Tip Technology	21	39
?? High quality of the product	21	39
?? Qualified Human Resources	20	37
?? Company’s Healthy Finance	12	22

It is of pointing out that the companies identify as their main strengths those competitive advantages that they understand that one has given them their positioning in the market.

- ?? The investigators identified that the three main strengths mark Image, tip technology and high quality of the product were based under the current conditions and not with relationship to future projections. These being still influenced by the diverse forms of protectionism that they enjoy with relationship to foreign competitors. For what they do not really give a competitive advantage distinguished in a future.
- ?? Regarding the qualified human resources, it is of pointing out the insufficient incentives and recognitions, as well as its low implication in the processes doesn't allow its appropriate use.
- ?? Alone 25% recognizes of preparing a solid financial system.

Opportunities

After the reduction they were 29 factors like opportunities

	Companies	%
?? Clients' potential growth	30	56
?? Opportunities to Export	14	26
?? Skills to develop new products	12	22
?? Joint Ventures	10	18
?? Alliances with competence	9	17

?? Most of the companies do not identify common opportunities and you specify them they do not really constitute opportunities, they were but well declarations of how to improve their internal capacities and non opportunities in the environment, what reflects a tendency of pessimism about the future possibilities.

?? It is significant that the main opportunity comes it in the potentialities of growth in number mainly of clients in base to the expansion in the national environment and in an exit toward the exterior.

?? Also comes it in the association with other, mainly to find solutions in the logistical chain and to achieve the commercialization of the product abroad.

Weaknesses

After the reduction they were 28 factors like weaknesses

	Companies	%
?? Inadequate administrative system	39	72
?? Low motivation and conflicts	16	30
?? Low Compensation to the workers	14	26
?? Ignorance of the market	11	20
?? Insufficient information systems	10	18

?? In the case specifies of the weaknesses, it is very significant that of the 28 factors identified by all the companies, 7 were expressly of administrative inadequacies, as the main weaknesses of the organization. In first I finish 39 companies, for 72% it recognized as a main factor the inadequate of the system in their group, while 30% identified the drop motivation and 26% the drop compensation of the workers. An analysis of these last two factors to exclude the repetitions in two factors for the same company, I hurtle that 22 companies, 41% identifies the motivation of the workers for diverse causes as a key factor in its weaknesses, Excluding the repetitions in taking more than a factor like nail of the weaknesses, we have that 45 companies, 83% identifies among the five more important factors from their weaknesses to inadequacies in the forms, methods and execution of its administration system or of some of its subsystems.

?? The analysis of the results obtained in the weaknesses and the results of the I Diagnose carried out they corroborate that indeed that the inadequacies in the development of the administrative systems are the main obstacle to reach the competitiveness that requires the new conditions.

Threats

After the reduction they were 20 factors like threats

	Companies	%
Foreign Competence	39	72
National Competence	30	56
Economy Problems	21	39
Peso Devaluation	6	11
Changes of Law	7	13

?? It is very significant the high level of identification of the companies like main threat that of the competition of the foreign companies with 72% and the competition of the companies in Mexican territory with 56%, when eliminating the companies that repeated these two threats, gives us that 44 for 81% of the companies that come among their main threats the competitions which reveals the uncertainties of how to improve the competitiveness of their own companies.

Attached: Analysis Results of Each One of the Investigated Elements, In Each One of the Carried Out Clusters

Profile and antecedents
In this chart they were eliminated for the publication the identification of the company and their classification according to the INEGI at the request of the management. (To see annexed TO for the results of each one of the analyzed companies).

TABLE 1. – CLASSIFICATION ACCORDING TO THE NUMBER OF WORKERS

	COMPANIES	**%**	
SMALL COMPANIES	19	32	1-50 EMPLOYEES
MEDIUM COMPANIES	19	32	51-300 EMPLOYEES
BIG COMPANIES	10	17	301-1000 EMPLOYEES
MULTINATIONAL	11	19	MORE THAN 1000 EMPLOYEES
TOTAL	59		

TABLE 1.1. – CLASSIFICATION ACCORDING TO THE FOUNDED YEAR
Three of the analyzed companies didn't specify their year of foundation, the result of the cluster gives us:

	COMPANIES	**%**
BEFORE 1980	0	0
1980 TO 1989	3	17.5
1990 TO 1999	12	67
2000 TO 2001	3	17.5

These results point to that the micro and small companies spread to disappear or to grow and to pass to another classification group, since 83% of the current ones was founded after 1999, mainly because Jalisco had been traditionally a state in the one that many small companies are believed.

If we analyze the 19 companies that have among 51 and 300 workers and the one that he/she has between 301 and 1000 the following thing it was observed

TABLE 1.2. – CLASSIFICATION ACCORDING TO THE FOUNDED YEAR AND NUMBER OF WORKERS

	51-300		**301-1000**	
	COMPANIES	**%**	COMPANIES	**%**
BEFORE 1970	1	6	5	46
1970 TO 1979	4	25	3	27
1980 TO 1989	5	31	1	9
AFTER 1990	6	38	2	18

In the first group the proportion is very small and in the second they are not able to represent a tendency of growth of the micro and small companies with the one of studying of the years, for what they spread to disappear, this means that the possibilities of survival of the micro and small companies in the last years are very limited.

TABLE 2. – ORGANIZATION AND CULTURE

	PROPERTY						**FORMALIZATION**						**CENTRALIZATION**						**STYLE**							
	FAMILIAR		**CORPORATION**		**INTER.**		**HIGH**		**MEDIUM**		**LOW**		**HIGH**		**MEDIUM**		**LOW**		**PATERNAL.**		**DICTAT.**		**P MORE D**		**CONSULT.**	
	COMP.	%	COMP.	~~%~~	COMP.	%	COMP.	%	COMP.	%	COMP.	%	COMP.	%	COMP.	%	COMP.	%	COMP.	%	COMP.	%	COMP.	%	COMP.	%
TOTAL	**25**	**42**	**22**	**38**	**12**	**20**	**30**	**51**	**16**	**27**	**13**	**22**	**36**	**63**	**14**	**24**	**7**	**12**	**27**	**48**	**25**	**45**	**52**	**93**	**4**	**7**
FAMILIAR	**25**	**100**					**5**	**20**	**9**	**36**	**11**	**44**	**11**	**44**	**9**	**39**	**3**	**13**	**14**	**58**	**10**	**42**	**24**	**100**	**0**	**0**
CORPORATION			**22**	**100**			**14**	**64**	**6**	**27**	**2**	**9**	**14**	**64**	**7**	**32**	**1**	**4**	**8**	**36**	**10**	**45**	**18**	**82**	**4**	**18**
INTERNATIONAL					**12**	**100**	**11**	**92**	**1**	**8**	**0**	**0**	**10**	**83**	**2**	**17**	**0**	**0**	**5**	**45**	**6**	**55**	**11**	**100**	**0**	**0**

	LEADERSHIP								**VALUES**						**CULTURAL FEATURES**							
	RECOGNOC.		**SAHRED.**		**WORDY**		**ABSENT**		**SHARED**		**NO SHARED.**		**WORDY**		**INNOV.**		**QUAL.**		**WIN EACH T.**		**STIMATE .**	
	COMP.	%	COMP.	%	COMP.	%	COMP.	%	COMP.	%	COMP.	%	COMP.	%	COMP.	%	COMP.	%	COMP.	%	COMP.	%
TOTAL	15	26	19	33	22	39	1	2	26	47	19	35	10	18	27	57	31	66	3	6	17	36
FAMILIAR	8	33	7	29	9	38	0	0	8	36	6	28	8	36	7	39	9	50	2	11	6	33
CORPORATION	5	29	10	45	6	27	1	5	14	67	5	24	2	9	13	72	12	66	2	11	6	33
INTERNATIONAL	2	18	2	18	7	64	0	0	4	33	8	67	0	0	8	73	9	82	0	0	3	27

TABLE 3. – STRATEGIC PLANNING

	TOTAL (59)				FAMILIAR (25)				CORP. (22)				INTERNATIONAL (82)			
	COMPANIES				COMPANIES				COMPANIES				COMPANIES			
	R	**COMP**	**%**	**% TOTAL**	**R**	**COMP**	**%**	**% TOTAL**	**R**	**COMP**	**%**	**% TOTAL**	**R**	**COMP**	**%**	**% TOTAL**
3.1 APPROACH	C	36	68	61	C	15	79	60	C	12	54	54	C	9	75	75
	DPO	11	19	17	DPO	4	21	7	DPO	5	23	23	DPO	1	8	8
	SC	2	4	3	S.C				S.C	2	9	9	S.C			
	AE	5	9	8	AE				AE	3	14	14	AE	2	17	17
3.2 THERE IS A STRATEGIC PLAN	EC	9	21	15	E.C	3	23	12	EC	6	33	27	EC			
	IC	13	30	22	I.C	4	31	16	IC	6	33	27	IC	3	25	25
	INC	21	49	16	INC	6	46	24	INC	6	33	27	INC	9	75	75
3.3 TIME	> 2	15	58	25	> 2	5	62	20	> 2	4	33	18	> 2	6	100	50
	> 5	7	27	12	> 5				> 5	7	58	32	> 5			
	ANUAL	4	15	7	ANUAL	3	38	12	ANUAL	1	8	4	ANUAL			
3.4 UPDATE	YES	23	47	39	YES	4	19	16	YES	10	59	45	YES	9	82	75
	NO	26	53	44	NO	17	81	68	NO	7	41	32	NO	2	18	17
3.5 PEOPLE WHO WORK ON IT	DU	3	8	5	DU	3	33	12	DU				DU			
	CA	20	51	34	CA				CA	10	56	45	CA	10	83	83
	DU	5	13	8	DU	2	22	8	DU	2	11	9	DU	1	8	8
	CE	6	15	10	CE	2	22	8	CE	4	22	18	CE			
	PG	3	8	5	PG	2	22	8	PG	1	6	4	PG			
	C	2	5	3	C				C	1	6	4	C	1	8	8

	TOTAL (59)				FAMILIAR (25)				CORP. (22)				INTERNATIONAL(82)			
	COMPANIES				COMPANIES				COMPANIES				COMPANIES			
	R	COMP	%	% TOTAL	R	COMP	%	% TOTAL	R	COMP	%	% TOTAL	R	COMP	%	% TOTAL
3.6 MISSION	P	16	38	27	P	3	23	12	P	6	33	27	P	7	58	58
	PD	5	11	8	PD	2	15	8	PD	1	6	4	PD	2	17	17
	G	22	51	37	G	8	61	32	G	11	61	50	6	3	25	25
3.7 STRATEGIC DIAGNOSIS	IB	27	60	46	IB	11	65	44	IB	11	65	50	IB	5	45	41
	I-R	18	40	30	IR	6	35	24	IR	6	35	27	IR	6	54	50
	I-M				IM				IM				IM			
	EM	31	69	52	EB	10	59	40	EB	10	59	45	EB	11	100	92
	E-R	10	22	17	ER	5	29	20	ER	5	29	23	ER			
	EM	4	9	7	EM	2	12	8	EM	2	12	9	EM			
3.8 COMPETITIVE STRENGTH	C-5	21	40	36	C-5	7	32	28	C-5	5	26	23	C5	9	75	75
	C-4	12	23	20	C-4	5	23	20	C-4	4	21	18	C4	3	25	25
	C-3	7	13	12	C-3	2	9	8	C-3	5	26	23	C-3			
	C<3	13	24	22	C<3	8	36	32	C<3	5	26	23	C<3			
3.9 STRUCTURE	B	18	33	30	B	3	13	12	B	9	47	41	B	6	50	50
	R	15	28	47	R	5	22	20	R	7	37	32	R	3	25	25
	M	21	39	66	M	15	65	60	M	3	16	14	M	3	25	25
3.1O VISION-OBJETIVES	B	23	50	39	B	5	33	20	B	9	47	41	B	9	75	75
	R	10	22	17	R	2	13	8	R	6	32	27	R	2	17	17

		M	13	20	22	M	8	53	32	M	4	21	18	M	1	8	8
3.11	**GAP**	YES	19	36	32	YES	3	14	12	YES	8	40	36	YES	8	67	67
		NO	34	64	58	NO	18	86	72	NO	12	60	54	NO	4	33	33
3.12	**MASTER STRATEGIES**	YES	18	35	30	YES	2	9	8	YES	9	45	40	YES	7	70	58
		NO	34	65	76	NO	20	91	80	NO	11	55	50	NO	3	30	25
3.13	**WAYS**	YES	19	36	32	YES	3	14	12	YES	8	40	36	YES	8	73	67
		NO	34	64	58	NO	19	86	76	NO	12	60	54	NO	3	27	25
3.14	**PRECISION**	YES	19	35	32	YES	3	14	12	YES	7	35	32	YES	9	75	75
		NO	35	65	59	NO	19	86	76	NO	13	65	59	NO	3	25	25
3.15	**CHANGE**	YES	38	69	64	YES	8	36	32	YES	18	86	82	YES	12	100	100
		NO	17	31	29	NO	14	64	56	NO	3	14	14	NO	0	0	0
3.16	**GROWING/DIVERSITY**	C-5	36	75	61	C-5	12	63	48	C-5	17	85	77	C-5	7	70	58
		D-5	21	44	36	D-5	7	37	28	D-5	9	45	41	D-5	5	50	42
3.17	**INTERNATIONAL PROJECTION**	YES	34	67	58	YES	9	45	36	YES	14	74	64	YES	11	92	92
		NO	17	33	29	NO	11	55	45	NO	5	26	23	NO	1	8	8
3.18	**COHERENCE**	YES	20	38	34	YES	2	9	8	YES	9	47	41	YES	9	75	75
		NO	33	42	56	NO	20	91	80	NO	10	53	45	NO	3	25	25

TABLE 4. – HUMAN RESOURCES

	TOTAL (59)				FAMILIAR (25)				CORP. (22)				INTERNATIONAL (82)			
	COMPANIES				COMPANIES				COMPANIES				COMPANIES			
	R	COMP	%	% TOTAL	R	COMP	%	% TOTAL	R	COMP	%	% TOTAL	R	COMP	%	% TOTAL
4.1 SELECTION	YES	51	88	86	YES	18	75	72	YES	21	95	95	YES	12	100	100
	NO	7	12	12	NO	6	25	24	NO	1	5	5	NO			
	BL	1		2	BL	1		4	BL				BL			
4.2 TRAINNING	YES	33	60	55	YES	10	43	40	YES	12	60	54	YES	11	92	92
	NO	22	40	37	NO	13	57	52	NO	8	40	36	NO	1	8	8
	BL	4		7	BL	2		8	BL	2			BL			
4.3 ENVIRONMENT	T	18	34	30	T	5	22	20	T	7	37	32	T	6	55	50
	A	35	66	59	A	18	82	72	A	12	63	54	A	5	45	42
	BL	6		11	BL	2		8	BL	3			BL	1		8
4.4 TURNOVER	A	8	17	14	A	4	21	16	A	1	6	5	A	3	33	25
	M	10	22	17	M	2	11	8	M	6	33	27	M	2	23	17
	B	28	61	47	B	13	68	52	B	11	61	50	B	4	44	33
	BL	13		22	BL	6		34	BL	4		18	BL	3		25
4.5 COMPENSATION	A	9	18	30	A	2	9	8	A	1	6	5	A	6	55	50
	M	23	45	39	M	13	59	52	M	8	44	36	M	2	18	17
	B	19	37	32	B	7	32	28	B	9	50	41	B	3	27	25
	BL	8		14	BL	3		12	BL	4		18	BL	1		8
4.6 PROMOTE LEADERSHIP	YES	22	41	32	YES	6	24	24	YES	7	39	32	YES	9	82	75
	NO	32	59	54	NO	19	76	76	NO	11	61	50	NO	2	19	17
		5		8						4		18		1		8
4.7 DEVELOP EMPOWERMENT	YES	14	29	24	YES	9	37	36	YES	3	20	14	YES	2	22	17
	NO	34	71	58	NO	15	63	60	NO	12	80	54	NO	7	78	58
		11		18		1		4		7		32		3		8
4.8 PARTICIPATION	YES	10	19	17	YES	2	4	8	YES	3	18	12	YES	5	50	42
	NO	42	81	71	NO	22	96	88	NO	15	83	60	NO	5	50	42
	BL	7		12		1		4		4		16		2		6

Conclusion

The new conditions that they impose the third industrial revolution, the quick globalization processes and deregulations of the economic processes, they impose new and dynamics forms of administration the companies if they want to achieve competitiveness. Three key elements for this development constitute the development of a strategic thought, a more flexible organization and dynamics and a leadership shared with the workers. It becomes necessary the research of the administrative processes in the companies, even amid the difficulties to obtain the information that they are derived of cultural concepts and managerial secrets. Without the total representative ness, non deliberate samples and not slanted to will, they can reveal tendencies. The results obtained in 59 companies investigated in the Jalisco State with preliminary character and to indicate tendencies, they corroborate us the inadequacies that in the processes of strategic planning and organizational, cultural changes and of leadership they exist to face the challenges of the competitiveness. It deepens on the possibilities of subsistence and development of the micro and small company, if we endorse that in the 15 companies with less than 51 workers, none existed before 1980 and in the 16 medium companies (between 51 and 300) investigated, alone one existed before 1970. The researchers identified that the three main strengths mark Image, tip technology and high quality of the product were based under the current conditions and not with relationship to future projections. Most of the companies do not identify common opportunities and you specify them they do not really constitute opportunities; they make but well declarations of how to improve their internal capacities and non opportunities in the environment, what reflects a tendency of pessimism about the future possibilities. In the case specifies of the weaknesses, it is very significant that of the 28 factors identified by all the companies, 7 were expressly of administrative inadequacies, as the main weaknesses of the organization. In first term 39 companies, for 72% recognized as a main factor the inadequate of the administrative system in its group. The companies, 30% identified the low motivation and 26% the low compensation of the workers. An analysis of these last two factors to exclude the repetitions in two factors for the same company, I hurtle that 22 companies, and 41% identifies the motivation of the workers for diverse causes as a key factor in its weaknesses. Excluding the repetitions in taking more than a factor like nail of the weaknesses, we have that 45 companies, 83% identifies among the five more important factors from its weaknesses to inadequacies in the forms, methods and execution of its administration system or of some of its subsystems. It is very significant the high level of identification of the companies like main threat that of the competition of the foreign companies with 72% and the competition of the companies in Mexican territory with 56%, when eliminating the companies that repeated these two threats, gives us that 44 for 81% of the companies that come among their main threats the competitions which reveals the uncertainties of how to improve the competitiveness of their own companies.

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Financing and Access to Medicines in Latin America: The Case of Mexico

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Abstract

In the industrialized countries the forms of financing of medicines, like the financing to the services of health, is not done by the out-of-pocket money of the households, and most of those expenses are made by some scheme of co-payment or direct subsidy to vulnerable groups. But in the non-industrialized countries the main form of financing comes from the out-of-pocket money of the households, as it is it the case of Mexico. For this reason is important to analyze the prices, since its level conditions the access to a suitable therapy.

In this work some characteristics of the financing of medicines and the practices of fixation of prices of the pharmaceutical industry in Mexico appear. Also some characteristics of the forms of access to medicines are examined according to the cost of the families stratified by deciles in the case of Mexico for period 1992-2000.

1. Background

In the industrialized countries the forms of financing of medicines, like the financing to the services of health, is not done by the out-of-pocket money of the households, and most of those expenses are made by some scheme of co-payment or direct subsidy to vulnerable groups. But in the non-industrialized countries the main form of financing comes from the out-of-pocket money of the households, as it is it the case of Mexico. For this reason is important to analyze the prices, since its level conditions the access to a suitable therapy.

The oligopoly characteristics of the pharmaceutical market in Mexico allow them to fix the prices of medicines to the companies of the sector. There are many examples of price variation at local level as well as at the international one. At local level there are different prices for equal products, also it has been documented the ample divergence of prices between brand-name products and the presentations with generic formulation. At the international level there is found a similar variation, but extended its magnitude. A crucial question about the right price of medicines is still remaining, because the access to medicines continues being limited in the countries non-industrialized like Mexico.

In general terms the options of financing to the health are not neutral in relation to the fairness. The public financing of services for the health with extended schemes of social security either via taxes is equitable forms the more of financing. On the other hand, the direct collection constitutes the most regressive form and inequitativa of financing, the experience indicates that the high quotas represent a high economic barrier for the access the services of health. Of this form, the concept of inequidad in the financing can be tied with the proportion of the familiar entrance that each group destines in attention to the health.

In this work some characteristics of the financing of medicines are discussed as well as the practices of fixation of prices of the pharmaceutical industry. Also some characteristics of the forms of access to medicines are examined according to the expenditure of the families stratified by deciles in the case of Mexico for period 1992-2000.

1.1 Forms of financing in health

The financing form defines the characteristics of the protection of the population as opposed to the health risks. This can happen in three directions, of healthy to patients, young people to old and rich to poor men. The securing supposes the disposition of bottoms to cover the expenses that an anticipated disease cannot cause. The saving means the disposition of bottoms to cover the expenses, which it is going away to incur the oldness inevitably, period in which the weight of the diseases is greater. The redistribution has a social component. It supposes the disposition of bottoms on the part of which they must more to cover the less the most favored necessities with, and than in addition they have a greater frequency of diseases. The redistribution degree varies according to the financing form.

In the form in which each patient one pays the service of attention to the health (payment by event) does not take place any protection to the familiar entrance. If a cousin based on the risk pays itself that is had at every moment (as it happens in most of the systems of insurances of private type) it provides a level of protection to the familiar entrance, as opposed to the financial effects of possible future diseases, according to the conditions of the contracted policy. If the financing is of public origin (imposed and/or schemes of social security) the protection to the familiar entrance is greater than in the previous cases, since in this form of financing it incorporates redistributive elements in the population.

From the point of view of the financing the fairness of the health system can be moderate analyzing to what extent the necessity to pay the service of health is inversely proportional to the financial resources of the individual. It can be understood of two ways: a) the inequalities must be different form and b) that all those that is equal are treated in the same way. In case of countries as England and Canada the evidence sample that its form of financing is more progressive, because the groups of greater income pay a greater proportion to the systems of health in relation to the groups of smaller income. The opposite happens in the case of the United States since its system of health finances with base to deprived insurances, in where the groups of smaller income have a limited access.

The defined fairness as equal treatment for equal necessity also varies. In general in all the countries the classes very socioeconomically more worked against are those than worse indicators of health have? Nevertheless, its consumption of services of health is not directly proportional to the necessities. The evidence sample, that England is more equitable than other countries of Europe. For the case of Latin America, in Peru, the number of hospitable, which debits by 1000 inhabitants, is three times superior in the quintil of greater income in relation to the quintil of smaller income.

1.2 Expenditure in health and medicines

The expenditure in health as much in relative terms as absolute shows one narrow relation with the level of economic development of the countries. Whereas in the industrialized countries the expenditure in health as a proportion of the GNP of the 8.3% is reached, in the AL&C region it is reached 6,1 %, and in absolute terms $1.777,00 and $367,00 would be spent respectively.

TABLE 1. HEALTH AND MEDICINE EXPENDITURE BY REGION

Region	**Medicine expenditure US**		**Private medicine expenditure as % total**
	per capita (US$)	*% PIB*	*%*
Africa, Sub-Sahara	8	0.9	65
Asia	12	0.6	81
Oriente Medio	27	0.7	74
América Latina	26	0.9	72
Economías en Transición	--	--	--
Economías de mercado establecidas	138	0.6	40

Source: Taken from: Velazquez German ET Alius. The Sanitary Reformation and financing of medicines. Series: Economy of the health and medicines, Not 6. The WHO, 1998. WHO/DAP98.3

Like the expenditure in health, the expenditure in medicines tends to be higher in high-income countries, of such form that near 80 % of the medicine market is concentrated in the industrialized countries. The annual expenditure per capita in medicines is very heterogeneous, because while in the industrialized countries has an average consumption per capita of $138.00 in the non-industrialized countries the expenditure is sensibly smaller, thus for the LAC region it is $26.00, and in Asian countries it is $12,00 and Africa it is of $8,00 dollars. One is due to make notice that the cost annual average in medicines of Japan and the United States are of $368.00 and $311.00 dollars respectively. The expenditure in medicines absorbs a significant part of the expenditure in health in the non-industrialized countries, which has turned it a fundamental problem of public policy, because it is still had to great segments of the population that still lack a regular access to essential medicines, in good measurement by the price of such and by its forms of financing. For example, in the case of Africa it is estimated that one third of the population does not have access to essential medicines. The access to essential medicines could lower the rates of mortality caused by the respiratory diseases, of malaria and tuberculosis, as well as of the episodes of diaorrhea for which the essential medicines have an answer in union of the services of health.

The expenditure in medicines in Latin America represents 17 % of the total expenditure in health, unlike the industrialized countries where the expenditure in medicines represents 8%. According to the estimations of the World-Healt Organization (the WHO), the cost in medicines as proportion of the cost in health reaches 40 % in Thailand and Indonesia, and some African countries east percentage is superior to 50 %. Additionally the relation of the expenditure in medicines in its relation with the GNP per capita for some selected countries, where it stands out that countries as Mexico and Argentina have a high proportion of the expenditure in medicines in relation to the expenditure in health, of pocket, the homes in the acquisition of medicines very are elevated.

The average expenditure financed by the household is 40 % in the industrialized countries (Picture 1), in addition is due to consider that most of this financing is under co-payment schemes. Still in the United States there has been a change in the form of financing of medicines, because for 1965 the 92.6% of medicines were bought with the direct payment of the households and by 1998 this mechanism it only represented the 26.6%. The opposite happens in the countries of low income where the expenditure by household out-of- pocket is elevated, in contrast to countries like Japan, England where this relation tends to be very low.

3. Price of Medicines

3.1 Pharmaceutical Market: size

The global pharmaceutical market ascends to $ 337 billion dollars in 1999, the 55 % of which it is consumed in only 8 industrialized countries; the market of the United States represents 25 % of the worldwide market. The market registry, a rate of annual growth: 7 % in Europe, 12% in Japan, and 15 % in the United States. With this rate of growth, the expenditure in medicines as proportion of the total cost in health in the United States happened of 5.4 % in 1990 to 7.9 %

TABLE 2. LINAMERICAN MEDICINE MARKET (US MILLIONS 1995; MANUFACTURER PRICES**)**

Country	Private market (a)	Total Market (b)	% (a/b)
Brasil	5,416	6,908	78
Argentina	3,173	3,681	86
México	2,205	3,223	68
Subtotal	10,794	13,812	78
Colombia	1,047	1,341	78
Venezuela	512	620	83
América Central	441	586	75
Perú	356	517	69
Chile	369	424	87
Uruguay	252	303	83
Ecuador	200	254	79
República Dominicana	170	201	85
Total	14,471	18,058	80

Fuente: Pharmaceutical Research and Manufacturers of America. Washington, D.C., PHARMA, 1996

For 1999, the participation of Latin America and the Caribbean in the worldwide medicine market are of 6.6 %, with a projected growth of 8 % annual for the following lustrum. Brazil, Mexico and Argentina participate with 72 % of the total market of AL&C. The private sector absorbs 80 % of the market according to the data in picture 2.

3.2. Structure of Market and prices

The price of medicines, like in any other good, is determined by the market structure. The level of prices of the competitive markets will tend to be smaller to the one of the noncompetitive markets, because the barriers to the access as the patents or the registered brand names have a smaller weight, as it would be the case of medicines with generic formulations.

A recent example on the elimination of the patents in the prices is had with the victory of the patent of the Zantac (ranitidina). In April of 1995 the price of the Zantac and the product in their generic formulation were very similar, but at the en d of the patent, the price of the generic product had been reduced in 80 %, and its market had expanded 55 times in a year time.

The medicine market is a market in where the great transnational companies erect barriers to the entrance due to their elevated cost of investigation and development as well as to its elevated cost in promotion and trade, which prevents the competition in prices in this market.

The annual expenditure in (R&D) of the 8 bigger transnational companies is superior to one billion dollars. Pfizer destined to R&D $2,279 million dollars in 1998, which represented 18.6 % of the value of its sales, and an amount very similar to the value of the total medicine sales of the Mexican private market in 1995. Nevertheless the expenses of marketing and promotion are superior to the one of R&D on new products; the cost of the trade of the first year of sales of a medicine is considered about the 85 % of the value of the sales. The cost of marketing and promotion represents between 20 % and 30 % on the value of the total sales. The market control that have the big pharmaceutical companies gives the capacity them of fixation of the prices of medicines. In Literature one sees that there are different prices for similar products between different countries, prices different for same products and the great difference from prices between generic and brand-name products.

In a study of Foundation ISALUD is shown the difference of prices for equal products, with the same pharmaceutical presentation and brand-names, between the Argentine market and the Brazilian, to see table 3; for example, the Voltaren shows a difference of prices of 208 % between both countries. Carlos Galdón shows similar information for the European countries, to see table 4. The simple average of the sample selected by Galdón throws that the prices of Holland and Germany register prices 189% and 169 % superior to those of Spain. It cannot have a countable explanation for the difference of prices of 221 % for the Ventolín between the Spanish market and the German.

3.3 The case of Mexico

The medicine prices in Mexico has been analyzed comparing the prices of the public sector, with products in generic formulation and the ones of the private sector based on of brand-names products. From 1993 to 1999 the price difference of prices in the Mexican market has come extending significantly (picture 3). The evolution of the prices of medicines in Mexico as of 1993, date of the liberation of the controls of prices, shows a tendency of clear growth in the case of medicines of the private sector, against a reduction in the prices of the public sector. In the private sector the purchase is made on the basis of brand-names products, and through the direct payment of the household for the purchase of medicines.

Whereas the price of medicines of the public sector is sensibly smaller to the one of the private sector, due to the diminution of the barriers to the entrance, due to its generic formulation without differentiation of products, and with base to offering a opened manifold bidding.

TABLE 3. AVERAGE PRICES PER UNIT: PRIVADO AND PUBLIC SECTOR 1993-1999

Year	Private	Public	Difference %
1993	3.04	0.83	266
1994	3.41	0.56	509
1995	2.74	0.50	448
1996	3.58	0.54	563
1997	3.46	0.55	529
1998	4.10	0.60	583
1999	4.80	0.56	757

Source: CANIFARMA

For the analysis of the prices of medicines, also are due to detail the margins of operation of the different agents who distribute the medicine. For the Mexican market, the level of prices of medicines is determined from the price of the product in the manufacture laboratory, to which it assigns to 18.5 % for the wholesale distributor and 21.5 % for the margin of operation for the pharmacist in new products (b) and of 18.3 % for the old products (a) (picture 4); in the case of Mexico the rate of the added value tax is 0.

TABLE 4. MEDICINE PRICE STRUCTURE

	A	B
Manufacturer prices	100.0	100.0
Wholesaler prices	118.5	118.5
Retail price	140.2	144.0

Source: IMS Pharmaceutical Index Mexico. A: Products with launching to the market previous to February 15 of 1975 B: Products with later launching to the market to February 15 of 1975

Foundation ISALUD shows the structure of the margins of operation and the tax rates with which the commercialization of medicines for European Argentina, Brazil and several countries is made. This table it is come off that while in Argentina a tax is applied to the consumption of 12.8 %, in Brazil the rate is of 0 %, but in Denmark reaches 20 %. The same dispersion is had as far as the operation margins and in retail sales

4. Access to Medicines in Mexico

The financing forms subordinate the access to the services of health, since a private financing corresponds with a limited access. The inequity in the financing to medicines is related to the proportion of the familiar income that each group destines to the attention to the health. In Mexico, the financing is basically private, which conditions the form of access to medicines since its consumption is not related to the necessities of health but to the availability of household income, most of the medicine is acquired as household out-of-pocket money. 17% of the medicines are dispensed through institutional channels without the direct collection of payment.

4.1 Household medicine expenditure

In this work the access to medicines in Mexico is analyzed through the economic information that is reported in the National Survey of Income and Expenditure (ENIGH) that publishes the INEGI. With this information the patterns of medicine consumption are shown in Mexico, by income levels. For this intention the most relevant results of medicines expenditure in relation to the health expenditure by groups of income for years 1992 and 2000 appear, additionally is elaborated the curve of Lorenz and the coefficient of Gini for the mentioned periods, like measurement of the expenditure concentration. The survey allows us to compare the expenditure in health with the remaining expenditure that the families make in Mexico. The classification registers eight headings of expenditure (Picture 5) that make the homes, such as: Feeding, Dress, House, Articles of cleaning and equipment of the home, Taken care of Doctors, Transport and vehicles, Education and Tourism, Articles and Services for the personal care. The health expenditure represents for most of the layers of income around 4%. It is possible to indicate that the low layers spend more in Foods with around 50%, whereas the high layers around 25% of its total expenditure. The results are different when analyzing the participation of the medicine expenditure with the rest of the expenses in health that the families make, the income layers spend of more heterogeneous way and the medicines expenditure is very significant, in relation to the hospital attention, dental consultations, doctor's care, etc.

TABLE 5. HOUSEHOLDS BY INCOME AND ESPENDITURE CATEGORIES

HOGARES A NIVEL NACIONAL POR LA COMPOSICION DE LOS GRANDES RUBROS DEL GASTO CORRIENTE MONETARIO TRIMESTRAL SEGUN DECILES DE HOGARES DE ACUERDO A SU INGRESO CORRIENTE MONETARIO TRIMESTRAL 2000

PARTICIPACION DEL GASTO ENTRE DE(	TOTAL	DECILES DE HOGARES a					DECILES DE HOGARES a				
RUBROS DE GASTO		I	II	III	IV	V	VI	VII	VIII	IX	X
GASTO CORRIENTE MONETARIO	100.00	9.51	9.99	10.07	10.09	10.09	10.12	10.00	10.11	10.10	9.91
ALIMENTOS Y BEBIDAS CONSUMIDAS Y FUERA DEL HOGAR Y TABACO	100.00	3.17	5.40	6.80	7.52	8.88	9.36	10.94	12.76	14.71	20.48
VESTIDO Y CALZADO	100.00	1.66	3.02	4.01	5.36	5.96	7.66	9.59	13.46	17.52	31.75
VIVIENDA, SERVICIOS DE CONSERVACION, ENERGIA ELECTRICA Y COMBUSTIBL	100.00	1.96	3.59	5.05	5.47	7.38	8.21	10.72	13.36	14.07	30.21
ARTICULOS Y SERVICIOS PARA LA LIMPIEZA Y CUIDADOS DE LA CASA, ENSERES DOMES-TICOS, MUEBLES, CRISTALERIA, UTENSILIOS DOMESTICOS Y BLANCOS	100.00	2.14	3.04	4.35	4.85	6.38	6.52	9.07	11.33	15.56	36.76
CUIDADOS MEDICOS Y CONSERVACION DE LA SALUD	100.00	2.77	3.44	5.25	4.51	6.07	7.58	9.94	9.95	15.85	34.64
TRANSPORTE, ADQUISICION, MANTENIMIENTO Y ACCESORIOS PARA VEHICULOS Y COMUNI-CACIONES	100.00	0.90	1.73	2.65	3.47	4.98	6.05	8.63	10.92	16.80	43.87
SERVICIOS Y ARTICULOS DE EDUCACION Y ESPARCIMIENTO, PAQUETES TURISTICOS Y PARA FIESTAS, HOSPEDAJE Y ALOJA	100.00	0.63	1.34	1.98	2.70	3.75	4.85	6.15	8.62	13.46	56.52
ARTICULOS Y SERVICIOS PARA EL CUIDADO PERSONAL, ACCESORIOS Y EFECTOS PERSO-NALES, OTROS GASTOS DIVERSOS Y TRANS-FERENCIAS	100.00	1.58	2.45	3.51	4.47	5.30	7.10	8.38	11.50	15.54	40.16

Source: Own elaboration from the information of the ENIGH that publishes INEGI. Third Trimester the 2000 so important increase that it has meant the cost in medicines for the different layers (deciles) from entrance, in the selected years, largely is a consequence of the increases in the prices that the pharmaceutical industry has registered, as it were in the previous chapter.

4.2 Indice of concentration

The coefficient of Gini is a concentration measurement, founded in the curve of Lorenz. This coefficient is used frequently to measure the inequality in the income. In this work the coefficient of Gini like measurement of concentration of the health expenditure and the medicine expenditure is considered. This coefficient takes values between zero and one, when the value approaches one indicates that there is a greater concentration of the expenditure, however, when the value of Gini approaches zero the concentration of the expenditure is smaller, is to say that exists a more egalitarian expenditure distribution. The curve of Lorenz is a graphical representation that shows the accumulated percentage of the income, in relation to the accumulated percentage of the households.

The estimations show that the coefficient of Gini reached in 1992 a value of 0.40 for the health expenditure of the households, whereas the coefficient for the medicine expenditure is of 0.29; which indicates that, the expenditure in health has a higher index of concentration than the expenditure of medicine. In 2000, the coefficient of Gini of the health expenditure is 0.42 and the one of medicines is 0.34. The previous results both indicate a growth in indices of concentration, but of more significant way the index of cost in medicines. (Cuadro 6)

TABLE 6.

COEFICIENTE DE GINI		
	1992	2000
SALUD	0.40	0.42
MEDICAMENTOS	0.29	0.34

Source: Own elaboration from the information of the ENIGH that publishes INEGI. Third Trimester 1992 Picture 7

In Fig. 1 and 2 are shown the curve of Lorenz for health and medicines in the mentioned years. These graphs reveal the dispersion of the expenses subjected to analysis in relation to the line of equidistribución; this line shows that to each decil of the homes would correspond 10% to him of the cost. For 1992, the results indicate that the first decil participated with the 2.2% in the health expenditure and with the 3.4% in the medicine expenditure. On the contrary, the decil of greater incomes reached 36% and 25% respectively. On the other hand, in the year 2000 shows to us that the first decil participated with the 2.7% in the health expenditure and with the 3.3 in the medicine expenditure, on the contrary the last decil reached 34.7% and 30.6% respectively.

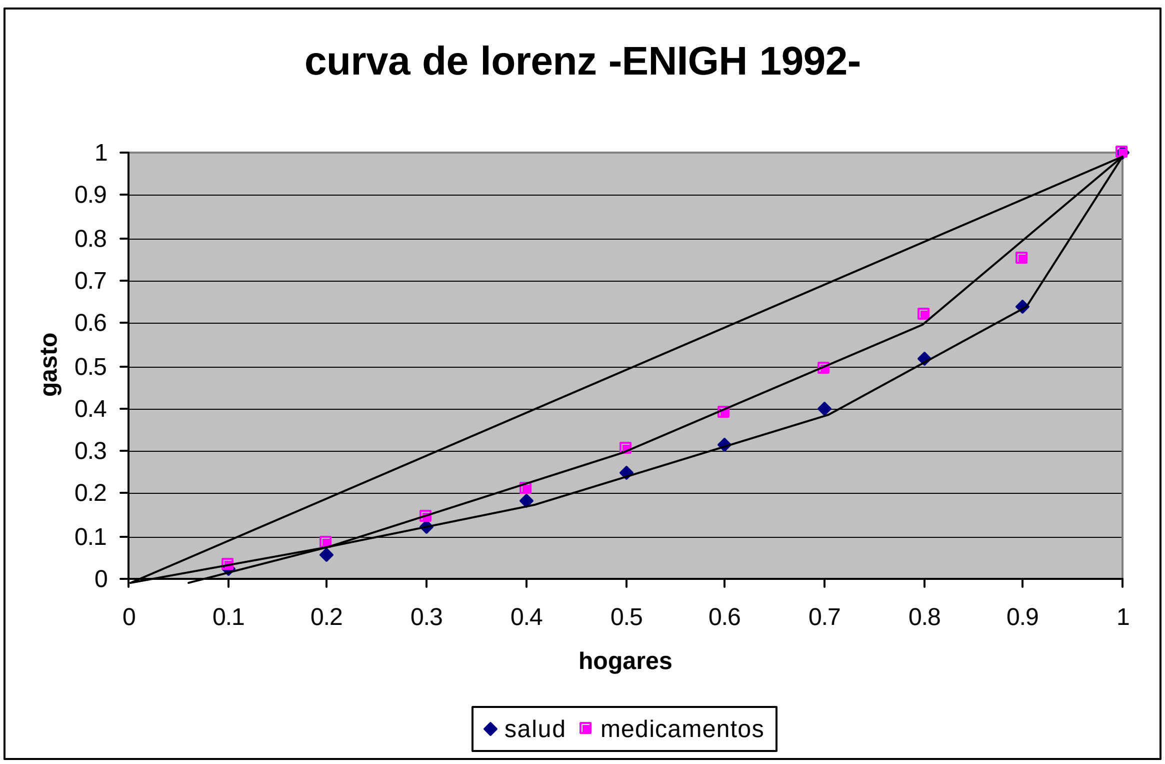

FIGURE.1.

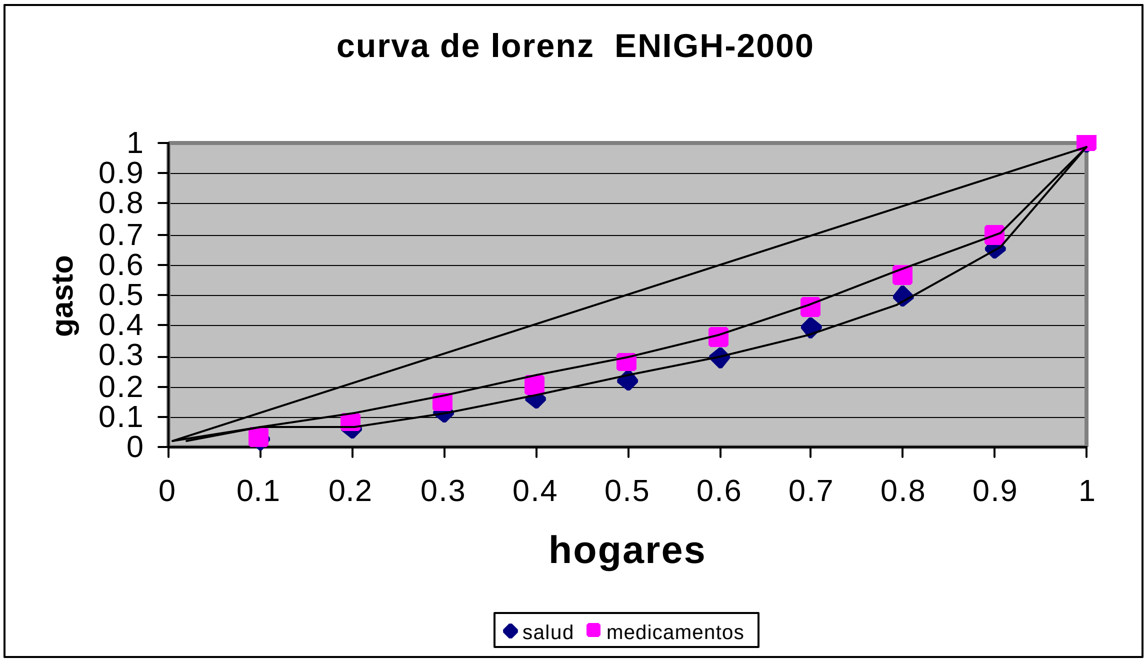

FIGURE 2.

In the period of study, the coefficient of Gini, and the curve of Lorenz shows the high concentration in the health and medicines, tendency that is accentuated in year 2000. The health expenditure in 1992 indicates that the decil of greater income is superior in 16.5 times in relation to the first decil. In the case of medicines this relation has a value of 7.3 times. For the year the 2000 health expenditure indicates that the decil of greater income is superior 12.9 times in relation to the first decil. On the other hand, the medicine reaches a value of 9.3 times.

5. Conclusion

The financing forms define the characteristics of the protection of the population facing the health risks. In the non-industrialized countries the main form of financing to medicines and in general to the health services of is by out-of-pocket money, which limits the access to a suitable therapy. The price of medicines is fundamental to define the access to drugs.

In Mexico, the pharmaceutical market is characterized being oligopolical. The great transnational companies erect barriers to the entrance with base to their elevated expenditure of R&D as well as to its elevated expenditure in marketing and promotion, which prevents the competition in prices in this market. The market control that has the big pharmaceutical companies gives the capacity them of fixation of the prices of medicines. As it is shown in this work, there are different prices for similar products between different countries, prices different for the same product and between generic and brand name products.

The evolution of the private prices of medicines in Mexico has shown since 1993 an important growth against a reduction in the prices average of the public sector. As the public sector buys the medicines in an open tender on a generic formulation without differentiation of registered brand names their prices tend to be lower than in the private sector where the purchase is made on the basis of brand names and by means of the direct payment of the families.

In Mexico, the financing is basically private, which conditions the form of access to medicines since its consumption is not related to the necessities of health but to the availability of household income; the public services only provide 17% of the medicine through institutional channels without reimbursement.

In Mexico, the private expenditure in medicines as proportion of the expenditure in health increased 37% in 8 years since 1992 to 2000. The patterns of medicine expenditure by income quintiles show that the low quintiles spend more in medicines than the high quintiles.

The coefficient of Gini for health is greater than the coefficient for medicines, in 1992 and 2000. What indicates that the cost in health is more unequal that in medicines, nevertheless deserves to stand out that the index of Gini in medicines increased in significant way by 2000.

These results show the increasing tendency of the cost in medicines that make the homes in all the deciles of income in Mexico, with a greater impact in the pocket of the poorest homes, without a doubt this growth responds largely to the characteristics of fixation of prices of the pharmaceutical market in Mexico.

For the countries of the Region of America it had to be clear that the objective of the extension of the cover and fairness in the access cannot be obtained through a financing that is sustained in the market mechanisms, in which the payment capacity depends on the level of familiar income. Still in the United States a change has been had in the form of financing of medicines, because for 1965 the 92.6% of medicines were bought with the direct payment of the household and in 1998 this mechanism only represented the 26.6%.

The expenditure in medicines in Latin America represents 17 % of the total expenditure in health, unlike the industrialized countries where the cost in medicines represents 8%. One has been that according to the estimations of the World-wide Organization of the Health (the WHO), the expenditure in medicines as proportion of the expenditure in health reaches 40 % in Thailand and Indonesia, and some African countries this percentage is even superior to 50 %.

Additionally, the relation of the expenditure in medicines in its relation with the GNP per capita for some selected countries is shown; where it stands out those countries as Mexico and Argentina has a high proportion of the expenditure in medicines in relation to the expenditure in health

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Contact the author for a list of references.

The Citizen Participation in Jalisco Regarding a Social Problem of Health: The HIV/AIDS

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Abstract

In our presentation, we will expose the form as is organized the participation that have the citizens in the Technical Counsel of Ngo's with Work in Aids, of COESIDA (*State counsel Against the Aids*) Jalisco, this is determined in certain form by the international agencies, especially Unaids (United Nations Aids) Mexico and the international instances that offer financial supports. Therefore in a first moment we will speak of the general factors that supported the rise of the Mexican Ngo's, being the most important that the state has not covered satisfactorily the multiple needs that have been generated for the expansion of the HIV/AIDS; that is the vision in which the civil organizations arise and that we do reference in this study. In a second moment, we will detail some epidemiological information that will give us a referencial context of the gravity of the illness. In a third moment, we will emphasize the way in which the international instances (especially UNAIDS) have influenced in the politics of health in respect of Aids in Mexico and Jalisco. In a fourth moment, we will describe the organizational structure of COESIDA, the Ngo's that integrate the Technical Counsel and the way that the4 international instances determine their operation. Finally, we will conclude doing emphasis in the advantages and disadvantages that involves for the Ngo's analyzed, to form part of the gear of the globalization.

Introduction

In recent years in our country, the presence of the citizen participation has increased and diversified in numerous organizations, establishing links among the State and the citizens. Actually in Mexico a big part of the population, who are in situations of extreme poverty, and with their expectations not satisfied through the undertaken actions by the governmental institutions, they have been obliged to look for alternatives. Though the private institutions are constituted like an option, turn out to be inaccessible for a great majority of the population. Consequently, the Ngo's arise as a viable and accessible social alternative, since, on one way, are conformed like organized groups of citizens that negotiate with the State, that its attend properly the needs of the population and either cover in a peripheral way multiple social needs. Another factor that has determined the growth of the Ngo's in Mexico, has been the democratization processes of the national life that have permitted the expression of the people to propose alternatives to the governmental initiatives; aspect that until the end of the 70' decade of the Twenty Century was unthinkable.

In Mexico the use of the term "organization of the civil society is very recent. Some analysts have aimed the earthquake of 1985 as a critical time in the development of the Ngo's in Mexico. The reason is that the social organizations began to play, in that active moment, one more active role. In 1988 many Ngo's found political expression. Protest and daily demonstrations after the presidential elections of that year, cause that many citizens, especially in Mexico City, realized the formation of a third sector. The awake of a real and tangible opposition to the presidential Government and counting with the tested capacity to mobilize human resources and matters for the democratic cause. This event permitted that they became in assets for the organization of a diversity of groups. (Olvera 1999)

In the National Plan of Development (PND in Spanish) of the actually president, Vicente Fox, the new role of the Ngo's is mentioned explicitly and is recognized into the interaction of the State with Society. The PND promote the participation of the Ngo's in the conformation of Counsels Citizens that evaluate and monitoring the programs of the National Plan. It Said that not governmental organizations, should be for excellence the mediators among the Society and the State. The importance of the constitution of these citizen agencies is situated in the change of paradigm in the Civil relations State-Society, established in the articles 25 and 26 constitutional, these articles was proposed to reform for the table of studies of the Reform of the State, prompted by Fox and directed by Muñoz Ledo (Bastidas 2002:31).

Concretely, for the problematic of the HIV/AIDS, embedded in a social and health setting of multiple shades that have complicated the epidemic control and surpassed the strategies implemented by the Secretary of Health, the Ngo's have worried to contribute individual solutions far away of the logic and the institutional speech to the problem of the Aids, but at the same time, complementary at its. It by means of the acquisition and retro-viral distribution of medicines to subjects with VIH/AIDS; the organization of information strategies on measures of prevention oriented to the population in general, as well as, the training to voluntary groups and others.

However, it given the limited reach of the structure and operation of the own Ngo's, these have presented the need of search work alliances so much toward the interior of the different organizations dedicated to the problem of the HIH/AIDS, as toward the health sector . To this respect, the authorities of health, product of the international actions and of the resources destined to Mexico to fight the Aids, have included or taken up again in their work agendas the development of a cooperative work with said organizations.

Product of the complex social and health problematic that includes the Syndrome of Immunodeficiency Acquired in the Mexican context, concretely in Jalisco, demand the existence of proposals and multidisciplinary studies that permit to establish bonds of analysis and comprehension of said reality and that they bind the contributions provided by the medical and social areas. To such effect, the present document shows the analysis of our local context, specifically in the metropolitan zone of Guadalajara, Jalisco talks about the role and participation of the citizenship understood this as an actor that is capable to develop in a organist way and not passive, alternate solutions to the private and governmental logic that permit to integrate in complementary form, the efforts directed to the prevention and attention of the VIH/AIDS , which, for Its sociocultural and medical complexity, requires of a plural approach.

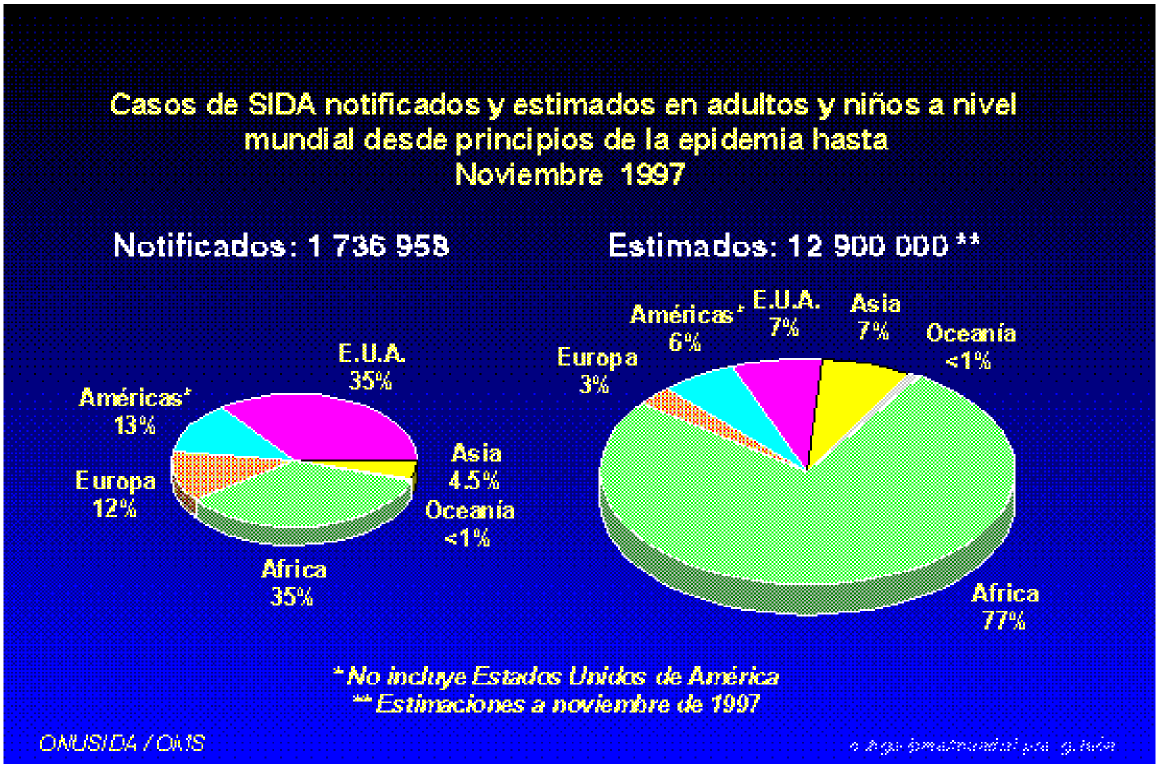
1. The Epidemiologic Problem of HIV/AIDS

At the beginning of the decade of 80´s in the Twenty Century, the first symptomatic patients of the virus of the human immunodeficiency (HIV) in a homosexual subjects captive population, and product of its quick dissemination to other groups of risks of the population in general, as the statistics show, it has obliged to carry out the unfold of large economic resources and of specific sanitary actions in a big scale, introduced first in the United States and promptly in the remainder of the world, directed to contain the expansion of the virus of the Aids. The carried out actions were directed primarily to the development and utilization of a specific pharmacology products oriented to fight the multiplicity of opportunistic pathogenic agents, as well as the installation of antiviral medicines capable to diminish the viral reproduction in the infected subjects. In second_point, carry out the epidemiological implementation of actions directed to the identification of the sexual contacts and the preventive creation of actions in viral terms of dissemination.

Nevertheless, the expansion of the HIV/AIDS covered in progressive form all the groups and social strata of the world, obliging the organizations involved, to reconsider the illness as an infectious syndrome acquired of pandemic scale: until 1997 he data reported by the UNAIDS (United Nations Aids), branch of the United Nations, responsible for coordinating the world sanitary actions in term of the Aids, registered 1,736,958 (notificated cases) comparing with 12,900,000 estimated. (Table 1)

In Mexico, the worry and sanitary aid in matter of HIV/AIDS, preferably has been oriented to the preventive development of strategies in epidemiological aspects, and of specifies attention to the health of bearers subjects groups of the virus of the human deficiency, not achieving with it to impact significantly in the development of new cases: In 1998, continuing with Ramos Jiménez (2000:16) in our country the official figure went of 38,000 cases, nevertheless the figure is undervalued, since the same one UNAIDS registers around 180 thousand cases. Besides in our country an expansion of the virus VIH/AIDS has been observed toward the rural zone by means of a phenomenon called the "ruralizatión", finding an algorithmic growth due to the shortage and limited health services presence in said zones, by the under educational level of the settlers and the difficulty of speaking of sexuality and sex. Finally, the main middle of broadcast is the sexual contact done not protect, observing a decreasing broadcast of man-man, man-woman, woman-man, and rare times woman-woman.

TABLE 1: AIDS CASES IN THE WORLD



Specifically, in the case of Jalisco, the extension of the illness, to June 30, the 2002 (period 1983-2002), situates to our state, in the third place in the national environment, with a total of 5,768 official cases. To understand the magnitude of the problem, of the total of cases registered since 1983 to the 2002 in the national environment, the 58.3% of the patients pass away and the 5.8% its state does not know itself, what adds a 64.1%. Likewise, in the 90.4% of the cases, the medium transmitter is the sexual one; therefore the blood broadcast has gone decreasing (9%) (National Counsel for the Prevention and Control of the HIV/AIDS)

As shows the Fig. 1, the zone of red that corresponds to the municipalities of Cuquio, Ixtlahuacan del Rio, Zapotlanejo and Tonalá are the areas that have the highest rate with 7. continue in order of importance, the municipalities of Tlajomulco de Zúñiga, Ixtlahuacan de los Membrillos and the municipalities that surround to the ZMG (Metropolitan zone of Guadalajara) (in blue but in smaller size) (Tlaquepaque and Zapopan) as well as the municipalities (in yellow) that surround to the Lake of Chapala. (In blue, but of greater size) The interesting thing is that the interior of the areas in red and yellow, concentrate a little more than 3 and medium millions of persons, by which, the number of persons infected HIV/AIDS is very high, since in the remainder of the municipalities we situate near two million of inhabitants.

In that sense, the majority of the civil organizations that have been created around the problematic of the Aids have its headquarters in the ZMG and implement its strategies in base to its relation with COESIDA and have like spatial framework the City of Guadalajara and its outskirts (Zapopan, Tonalá, Tlaquepaque, Zapotlanejo, Tlajomulco of Zúñiga,, El Salto and the municipalities close to the lake of Chapala) that mean, areas with more cases.

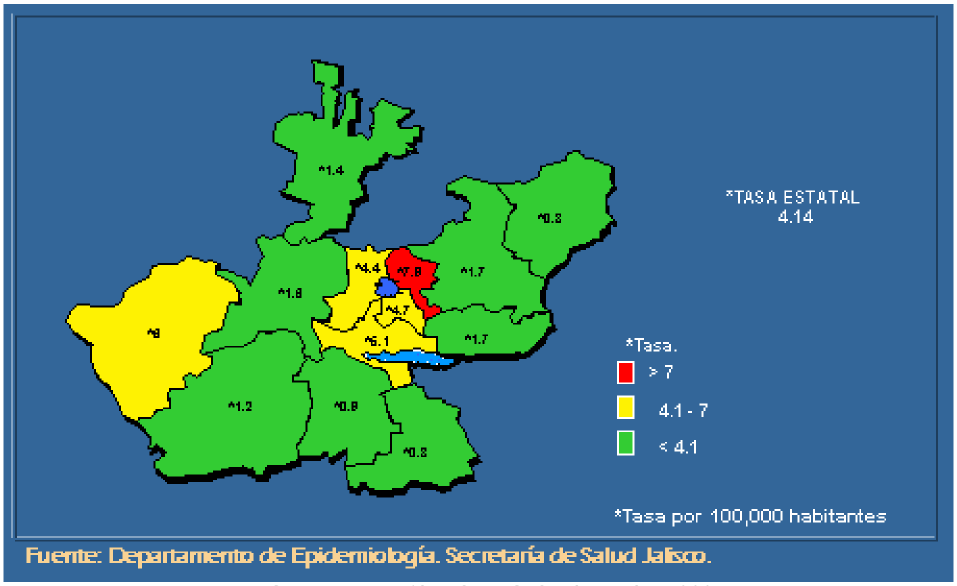


FIGURE 1: HIV/AIDS REGIONAL MAP 2000

The tables 2 and 3 represent, perhaps the most worrying data of the Aids: Its direct impact in the youth and in the adult phase, since the highest incident of cases is given among the 25 and 44 years, that is to say, during the most productive periods for the human society. From there not being strange, that the persons that compose the organizations of the civil society worried about this problematic, been in a majority way, youths and adult youths.

TABLE: 2 AGE GROUP INCIDENCE 2000

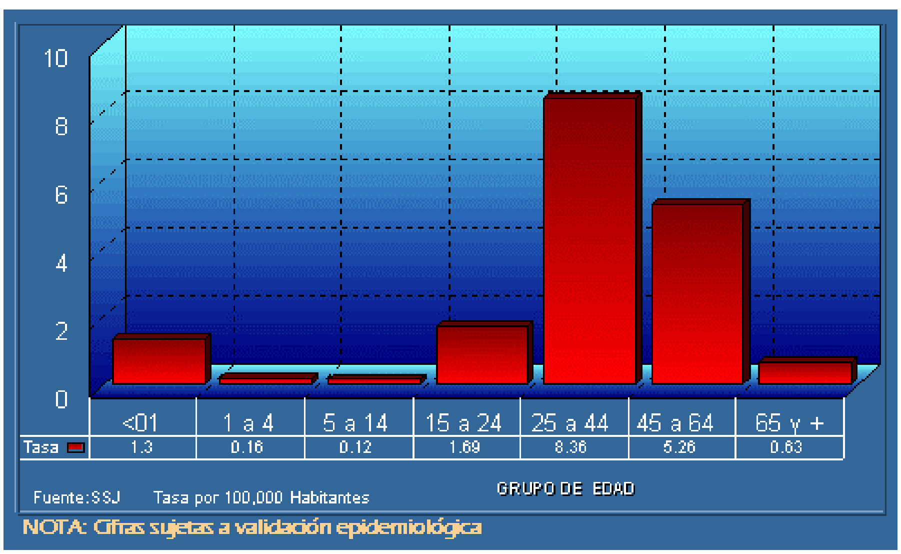
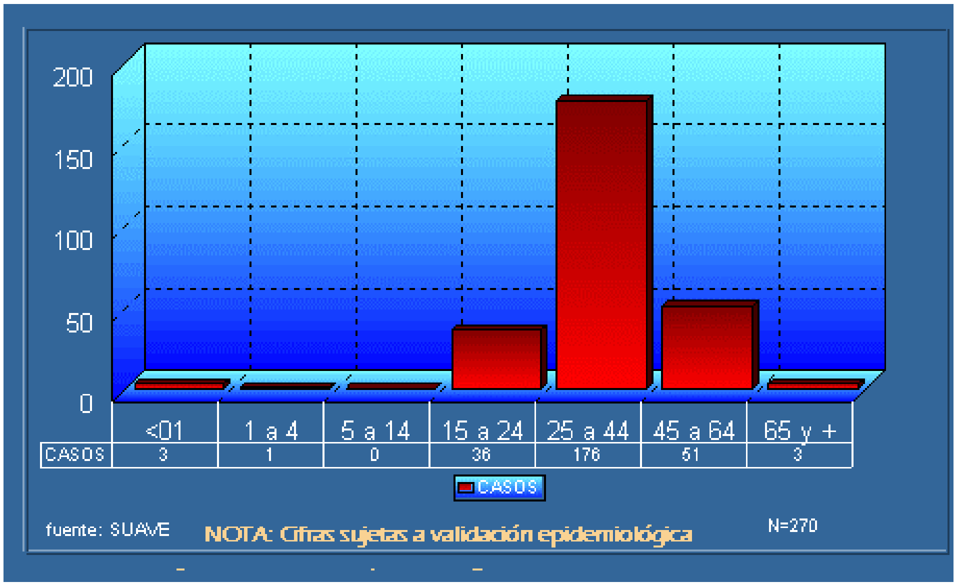


TABLE: 3 AGE GROUPS CASES



2. The Influence of International Organizations in Mexico Opposite to HIV/AIDS.

The HIV/AIDS being a world illness of reaches, obliged the international rise of instances linked to the United Nations, which, to be more efficient, have sought - since 1987 when the "badly of the century" obliged various countries to request supports - strategic alliances with international agencies financiers. Likewise, especially because of the rise of UNAIDS (at the beginning of the 90) and its installation in Mexico (1995) the fight against the HIV/AIDS in our country and Jalisco have been determined by these global instances, spreading like center of its strategy, the participation of the citizens in Ngo'. We see the details.

The participation of the United Nations in the fight against the Aids is mended in 1987, when the "United Nations Development Programme" (UNDP) began to receive of the governments support petitions –among them the Mexican - to the programs of fight against the HIV/AIDS (www.un.org/organismos/grupos/SNU23106.html) In answer to those petitions, that same year was formed in Mexico the first Mexican agency specialized in the fight against this badly: The National Committee against the HIV/AIDS. A later year is created the National Counsel Against the Aids (CONASIDA) with financing - among others international instances - of UNDP and the World Bank Continuing the tendency of the central Mexican political of the epoch, they arose to way of retorts, the State Counsel Against the Aids in the states, among them COESIDA (State Counsel Against the Aids) in the state of Jalisco. (www.conasida.org.mx)

At the beginning of the decade of the 90' of the century XX, the instance by excellence in the fight against the Aids is created: UNAIDS which takes up again the idea of the red tie that in 1991 a U.S. group of artists utilized to call the attention on that problem and it was incorporated to the logo of this world organization, being at present symbolic. In order to establishing a connectional cooperation more specialized, UNAIDS promoted the multinational integration of agencies of regional type, to create fronts of fight better orchestrated. One example of them, in case of Latin America, is the creation in 1994 of the Latin-American and the Caribbean Council with organizations that work with HIV/AIDS (LACCASO) having in their first members Mexico, Costa Rica y Venezuela. Being incorporated a later year (1995) Mexico to the countries where UNAIDS has presence.

A transcendental event inside these efforts of world strengthening against it pandemic, happened in 1996 on January first with the integration of the sponsor member that gave it an important financial support.The eight UNAIDS cosponsoring agencies are:

- ?? United Nations Children's Fund (UNICEF)
- ?? United Nations Development Programme (UNDP)
- ?? United Nations Population Fund (UNFPA)
- ?? United Nations Office on Drugs and Crime (UNODC)
- ?? International Labour Organization (ILO)
- ?? United Nations Educational, Scientific and Cultural Organization(UNESCO)
- ?? World Health Organization (WHO)
- ?? World Bank

Speaking of the influence that has UNAIDS in Mexico we find that since its foundation in our country has sought to give him, on the one hand, a direct support to CONASIDA (spreading for result, a weight in the restructurings, decisions and strategies of this public agency) and by another, supports to Ngo's that perform works in Aids.

Inside the first aspect we can comment that the Framework of Action of the Operating System of UNAIDS Mexico is supported in three parameters: 1) Objective of the P.N.D. 2) The Strategic Note of the Country (SNC) that is the document that orients the politics of the Government of Mexico for the mobilization of resources of the outside, particularly, the coordinated through the United Nations system.

As for the second aspect, we situate the program of "Institutional Strengthening of Ngo's with work in Aids" for to be supported, should cover the following requirements:

a) Coherence in the design, implementation and evaluation of projects
b) Location in strategic geographical areas where there be greater incident of the pandemic, in order to facing the fight against the Aids in Mexico
c) Collective Benefit in its projects (not exclusive for specific groups)

(www.un.org/organismos/grupos/SNU23106.html)

An example of both aspects, can be illustrate with the role that has UNAIDS Mexico as for the negotiation of resources with the financial system Breton Wood (formed by the I.M.F and the World Bank.) was the credit of $ 350 MDD that the World Bank offered to Mexico to develop – from the 2001 –of the "Program of Quality, Equity and Development" where is oriented the fight against the VIH/AIDS, on the one hand, to the health attention networks creation that seeks that all the instances of health of the country be involved in this fight and by the other, the utilization and training of the Ngo's as to apply different suitable media actions of information, education and communication in Well of the community. (www.un.org/organismos/grupos/SNU23106.html)

As for the case of the networks of Health, we find that one of the main proposals of the new National Counsel for the Prevention and Control of Aids (that replaces CONASIDA from July of the 2003) is the inclusion of all the public instances of Health of the country in the fight against the Aids, together with the acceleration of decentralization processes of the health public services, political established for to be executed through the lending of the World Bank. Speaking of the intervention of the Ngo' s in the governmental actions, we situate the case of the inaugural Meeting in November 2001 of the Committee of Monitoring and Evaluation of the CONASIDA where was integrated to the civil Society ; the academy; the federation companies; the health institutions (IMSS/ISSSTE/SEDENA/PEMEX) (Mexican institute of the Social, Insurance Social Institute of Security for the Workers of the State, Secretary of the National Defense, Petroleos Mexican, respectively); other instances as the National Institute of Medical Sciences and Nutrition Salvador Zubirán and the Program of quality, equity and development in Health. (PROCEDES); and the CENSIDA (National fund for the patients of Aids), with the objective to structure an evaluation that permit to link the actions and the proposals of this agency. (www.conasida.org.mx)

It is interesting to make out how the credits of the international instances, of some way they have been related to the changes of the governmental instances of health, as for that promote a greater citizen participation in their actions, on the one hand, and by another, restructure their structures orienting them each time to the support networks idea and the decentralization. Subsequently we will speak of COESIDA, Jalisco and the influence that has this international context in their organization, and their bonds with the Ngo's local.

3. The Operation of the COESIDA and Its Bonds with the Local Ngo's

In Jalisco State , by decree of the governor Enrique Álvarez del Castillo,, the State Counsel for the Prevention of the Syndrome of immunodeficiency was created (COESIDA) in 1988, that works in coordination with the national programs and with the national Agency CONASIDA; and in 1995 was restructured, being conformed 3 General Co ordinations: Sub counsel , Admo. and Accounting and Decentralization, just as the Figure 2 illustrates.

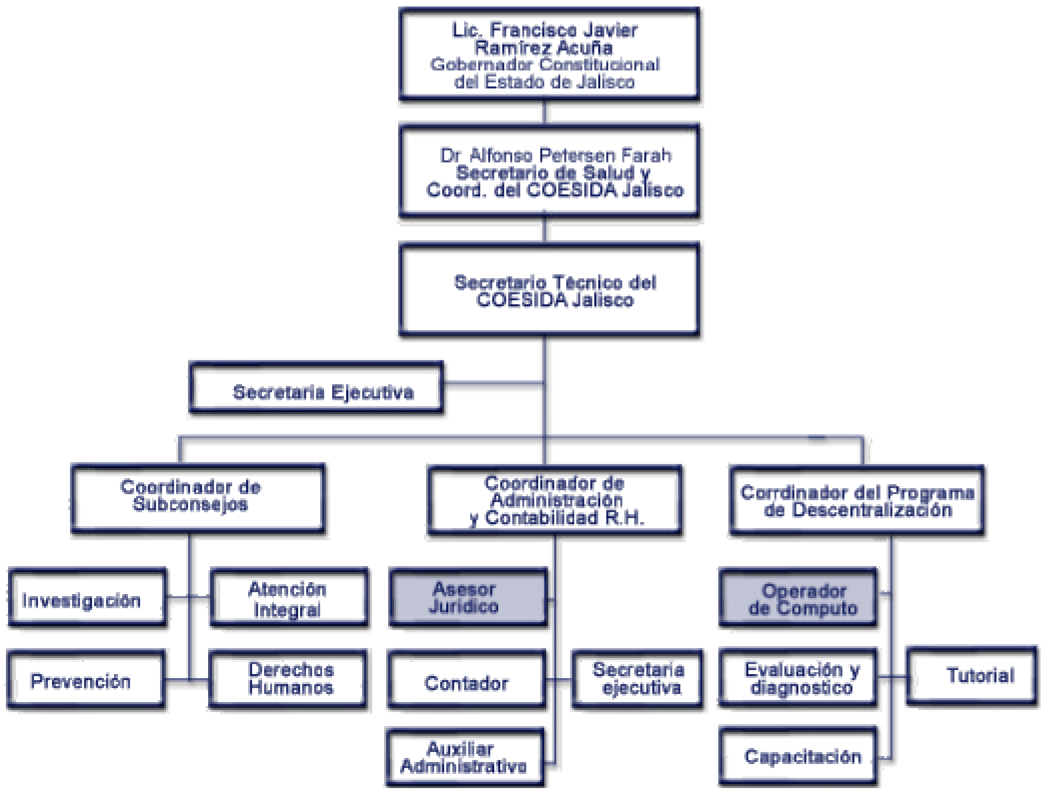


FIGURE: 2 CHART OF COESIDA

Of the first one, four subcounsels are removed directed to undertake the different areas of the priority work in VIH/AIDS in the State:

· Investigation
· Prevention
· Integral Attention
· Human Rights

The Administrative General Coordination counts with a legal area of advising, takes charge of the correct application of the financial, material, and human resources as well as of the legal matters of the COESIDA. Finally the Coordination of the Program of Decentralization three departments depend: Tutorial, Training and Advising, Evaluation and Diagnostic, that take charge of the work to municipal level with the COMUSIDAS. (Municipal Counsels of the Aids)

Of complementary form, was structured from the 2001, a Technical Counsel of Ngo's With Work in Aids, composed of 11 civil organizations representative of the Jalisco's Society that are entrusted, in a priority way, in the work in favor of the Aids in coordination with COESIDA. The organizations that conform them, and that are our subject of study are:

- Amigos Previniendo el Sida
- Colega
- Checos
- Homo Sapiens
- Lazos Unidos por la Vihda
- Mesón de la Misericordia
- Proyecto Azomalli
- Ser Humano
- Vida Positiva
- Vihas de Vida
- Viva la Vihda.

At present the Coesida, presents to the interior of its organization activities that permit to add efforts since different perspectives of analysis and work. With it, the incorporation of forty-seven representative ecclesiastical, university, and governmental instances of the Society in Jalisco, as for example: the CEDH (State commission of Human Rights), Civil Hospitals of Guadalajara, IMSS (CLÍNIC MENCHACA) S.S.J (Secretary of Salubridad of Aid)), S.S.A., I.S.S.S.T.E., CODE (State Counsel of the Sport) Jalisco, The City Hall of Guadalajara, Zapopan, Tlaquepaque, Tonalá, PGR (Procudaduria General of the Republic), SEDENA, ITESO (Technological Institute of Upper Studies of West) U.D.G. (University Of Guadalajara) and D.I.F (Integral development of the Family); as well as diverse civil organizations as Azomalli A.C., Homo Sapiens A.C., Vihas de Vida, Mesón de la Misericordia Divina, Vida Positiva A.C., Colega, Amigos Previniendo el Sida A.C, Checcos. A.C. Frenpavih, Voluntariado de Tanatologia A.C, Medical Association of Jalisco and Mexican School of Civil Sexuality Association (ssj.jalisco.gob.mx/coesida/index.html)

As for The fear of discussion, we observe, on the one hand, that the restructurings that had COESIDA in 1995 and the 2001, coincide with the installation of UNAIDS Mexico (1995) and on the other hand, with the strategy of this world agency to utilize to the Ngo's, on the one hand, as intermediaries among the global instances for the obtaining of supports, and by the other, as a middle so that the citizen integrated in Ngo's carry out activities that previously were developed for the state (in its charitable phase).

Is curious, the existing coincidence among the program of UNAIDS of "Institutional Strengthening of Ngo's with work in Aids" and the name of the instance of COESIDA that works directly with the local not governmental organizations , named "Technical Counsel of Ngo's With Work in Aids". Also is worthy to note that the organizations integrated to this technical counsel, receive supports of the Government of the State of Jalisco (that at the same time receive funds of the Government of Mexico and of course of the World Bank.) by which develops a chain of commands, where the politics against the Aids are gestated in international instances and contextualized according to the strategic note of the country, the health Objectives contemplated in the PND, to finally arrive to the state instances of health. While Ngo's of Mexico City, as "Collective Sun of Mexico" of some way has himself "globalized" (in the sense that since 1995 guard bonds with Latin-American Ngo's and of other countries) the organizations that fight against the Aids in Jalisco, does not have a clear tie with organizations of other countries. The interesting thing of this, is that in spite of not existing these relations, these instances of citizens, are affected for the globalization, but in a passive form, that is to say, orchestrate part of their continuity, in base to the financial supports that receive of COESIDA, but without questioning them or to seek supports of all types in Ngo's of other countries that permit them to have a vision of assembly in this problematic .

Conclusion

Today is undeniable the exponential growth that the Aids epidemic has come presenting everywhere. In Mexico this quick and maintained expansion of the illness has caused an on health services demand in the different governmental institutions, causing that these institutions be found in a situation of cover and insufficient service. Before these limitations in the quantity and quality of the services offered to the population of patients with Aids, the civil society is organized in Ngo's since a different logic to the institutional speech, with complementary actions oriented to supply said lacks: acquisition of antiviral medicines, obtain of cares and psychological accompaniment to terminal patient, legal advising, hospitalization and preventive programs of education toward the illness. In Jalisco, as in the remainder of our country, the different Ngo's have come developing a presence and progressive participation each time more noticeable in our society, product of the efforts and actions undertaken during its period of existence. Nevertheless, the international pressures of economic character toward Mexico and the external influence on the health politics planning in matter of HIV/AIDS, have installed the conditions and adequate social settings capable to promote and to maintain the citizen participation and to include the civil Society in the supervision of the governmental actions and in the decisions' takes to the interior of the state counsel against the Aids. However, to be inserted the Ngo's in the processes of globalization, It involves specific advantages and disadvantages, that as already was mentioned, keep a passive relation with the same one, simply continuing the established politics by the international instances, in which receive, in an indirect form, the financial and technical supports. This is a disadvantage since its survival, in one way, depends on these politics and the supports that accompany them and if don't adapt themselves, they wont have a continuity. So, that this relation was profitable, have to be established linking with International Ngo's that will open financing opportunities alternate to UNAIDS, as well as processes of contribution and exchange of experiences and points of view on the development of the HIV/AIDS in other latitude. Because of it, we consider that the citizen participation could exercise a strategic and significant intervention since the present problem of health and to guarantee its continuance, upon meeting four conditions:

1. Creation of an adequate system of structure and organization with clear definition of positions and functions.
2. Utilization of adequate sustainable of auto financial mechanisms through the fiscal exercise of donations and perceptions.
3. The professional training of each member in specific activities indicated in the profiles of positions.
4. Establishment of work alliances to the interior of other not governmental agencies as toward the different governmental dependences of health.

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Foreign Direct Investments and Efficiency of Structural Changes in Local Economy: The Case of Lithuania

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Abstract

The paper deals with foreign direct investments (FDI) in Lithuania. An issue of priority is to determine if inflow of foreign capital in all cases contributes sufficiently to development of national economy. Investigation of controversial impact of FDI on Lithuania is based on theories presented by concise review of the literature examining the role of FDI in transition economies. The detailed analysis of FDI directed to different sectors of Lithuanian economy let to determine cases when globalization retards economic development of host country.

Introduction

In the context of European Union enlargement and economic restructuring of national economies transition countries usually see inflow of foreign capital as an issue of priority. Such an approach to FDI, as a rule, dictates appropriate policy of government directed to providing of various stimuli to foreign investors. Meanwhile, certain cases raise doubts if globalization unconditionally guaranties growth of productivity, increase of quantity and quality of provided goods and services.

Presented analysis of FDI in Lithuania is aimed to segment inflows of foreign capital and quantitatively evaluate impact of different investments on growth of Lithuanian economy. Analysis of segmented by sectors of economy FDI in Lithuania would let to identify cases when globalization represent certain risk for transition countries.

Theoretical background of analysis

Theoretical discussion concerning impact of FDI on host country economy focuses on whether globalization of foreign enterprises contributes or retards development of local economic entities.

Positive approach to globalization is dictated by a most cited possibility that FDI generates productivity spillovers for the host economy [1]. One idea is that multinational enterprises possess superior production technology and management techniques, some of which are captured by local firms when multinationals locate in a particular economy. A related source of spillovers is forward and backward linkages between multinational and host-economy firms [3], which may result from multinationals providing inputs at lower cost to local buyers or by their increased demand for inputs produced by local suppliers. Despite spillovers are key factor supporting positive impact of globalization, but their existence and magnitude difficult to establish empirically.

Negative approach to globalization is represented by view, according which multinationals mostly are oligopolistic companies, locating in protected markets with high barriers to entry and increasing market concentration. They extract rent, siphon off capital through preferred access to local capital markets, and drive domestic producers out of business [2]. To continue presented view we could add, that special favorable conditions guarantied by high barriers of entry don't encourage increase of productivity in terms of increased quality or volume of production. That finally means that globalization in such a case don't contribute sufficiently to development of host country economy. Despite presented view is more characteristic for earlier researchers, as we will show later it still can be attributed to very topical issues.

To summarize key results of the literature on globalization impact on host country economy, we have seen that in theory FDI impacts national welfare in two diametrically opposite directions: on the one hand it raises the productivity of domestic economy but, on the other hand, it drives domestic producers out of market, endeavors favorable uncompetitive position in the market, which can lead to appropriate loses conditioned characteristic by monopoly.

Controversially evaluated role of cross-border capital flows dictated the angle of presented investigation. The assumption has been made: the composition of capital flows finally dictates impact of FDI on development of national economy. Hence, it's composition of FDI by sectors of economy and magnitude of investments, what ultimately matters, when impact of globalization is scrutinized.

Methodology of research

In quantitative terms economic growth the most accurately could be expressed through increase of volume of produced goods and services provided during specific period of time, or to put it into another words, though increase of Gross Domestic Product (GDP). Aiming to evaluate impact of segmented foreign capital inflows on growth of host economy the following approach has been adopted. A premise has been made that the correlation between GDP and separate inflows FDI, expressed as percentage share of total FDI directed the country, represent a most accurate measure of efficiency of globalization of separate sectors of economy. Hence, in presented paper emphasis has been put on percentage composition of FDI rather than on absolute values of FDI expressed in monetary terms. Such approach finally lets to take into account change in magnitude of FDI flows directed to certain sectors of economy, when absolute value of the same indicator doesn't provide possibility to focus on impact of dissemination of FDI on national economy. Finally, concentration on FDI structure leads to comparison of it to present structure of GDP by economic sectors, and, consequently, to prediction of future trends of restructuring economy of host country.

Analysis of FDI tendencies in Lithuania

Foreign Direct Investments according methodic of International Monetary Fund (Detail Benchmark Definition Foreign Direct Investment) are such investments on basis of which long-term relationships and interests between FDI investor and host enterprise have being formed [4]. Limit of 10 and more percent of common process of management of enterprise-recipient of capital. Hence, only investments exceeding the pointed out limit are considered as foreign direct investments and represent target of our investigation. Characterizing definition of FDI, it should be noted, that criteria applicable to FDI identification don't involve aspects related with mode of investments have been made. Hence, "green field" investments in these terms have been equalized to privatization revenues, what from the point of view of economic grow, the most probably, will generate quite different effect.

There could be distinguished three stages of globalization process in Lithuania. The first stage continued till 1991, the second lasted from 1991 to 1996, and the third stage has started in 1996. The laws regulating processes of globalization in Lithuania have been adopted comparatively later than in other transition countries. This factor is considered to be not of the least importance when trying to identify main reasons of globalization tendencies presented below.

Hence, the more significant inflow of foreign capital started only Lithuania regained its independence in 1990. In this year economic reform started and the main laws regulating economic activity in market conditions were adopted. This point in time is held as the actual beginning of transition and globalization processes. Notably, that in year 1991 it was recorded seven times more joint ventures than during three previous years and FDI reached 32 mln. Litas. During the very first years of transition rate of FDI growth was insignificant, most probably due to instable economic situation on country: the first years of independence were characterized by high inflation, series of bank crises, vague conceptions of future economic reform etc. Situation gradually improved and in year 1994 completely stabilized. Therefore we have chosen this year as initial point for our more thorough analysis of FDI tendencies.

Since 1994 speeding up economical reform, growing GDP and more stable economical environment measured by significantly reduced rates of inflation played key role in attracting foreign capital into country (FIG. 1). Intensive privatization stood for the main form of foreign investment and could be identified as one of the most important channels of FDI inflows.

More close view to FDI dynamics in Lithuania leads to observation that the major part of interested in globalization foreign firms entered market of the host country during the first several years after independence regaining. According poll organized by Lithuanian Development Agency [4], e.g. in 1996 more than 60% of new FDI were made by investors, who were increasing scale of their activity in Lithuania, i.e. only 40% of capital inflows came from new foreign firms. Scrutinizing process of globalization in numerical terms we have to emphasize that in 1998 total amount of foreign capital flows equaled to one, which was directed to Lithuania during a whole period from 1994 to 1997, and up to year 2001 FDI increase compared with 1996 was several times greater. Again, privatization in years of higher FDI played rather important role in attracting capital flows.

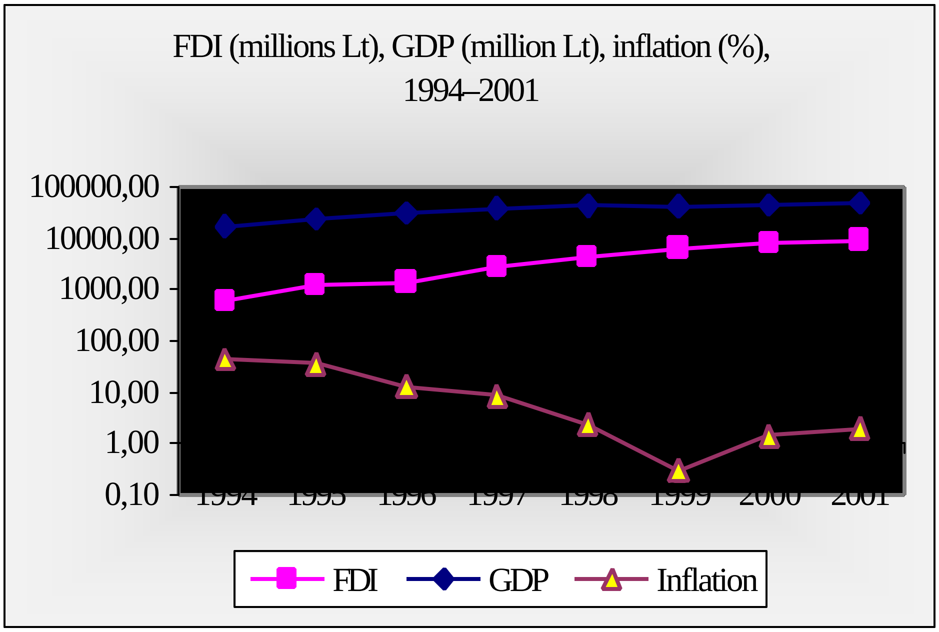

FIG. 1: FDI, GDP AND INFLATION DYNAMICS IN 1994-2001

Final target of presented investigation is to determine if inflow of foreign capital in all cases contributes sufficiently to development of national economy. Such approach to globalization efficiency requires detailed analysis of FDI composition by different sectors of economy. Detailed analysis of FDI composition should start from identification of main targets of interest of foreign investors. Lithuanian GDP structure by sectors of economy (Appendix 1) lets to distinguish four main branches of Lithuanian economy: services, industry, agriculture and construction.

Close look to FDI structure (FIG. 2) reveals that foreign investors have found those branches of Lithuanian economy not equally attractive.

Distribution of FDI among main for Lithuania sectors of economy has been quite uneven. As we see, foreign investors have expressed obvious interest in service sector. Notable, that comparatively higher investment into services vis-à-vis production corresponds to tendencies of global economy: in many countries structure of economies shifts towards services sectors. In Lithuania percentage share of FDI put into service sector in 1995-2001 increased from 47.95% to 66.0%. Especially increased FDI share directed to financial intermediation (FIG. 3). Privatization of Lithuanian Savings Bank and Agricultural Bank significantly contributed to latter increase of FDI share. Telecommunication sector also attracted comparatively high FDI. Privatization of such public monopoly as Lithuanian Telecom and intensive development of mobile communication have conditioned significant inflows of foreign capital. “Green field” investments have been more characteristic for wholesale and retail trade sector (in FIG. 3 dynamics of FDI into main activities of interest comprising service and industry sectors is presented).

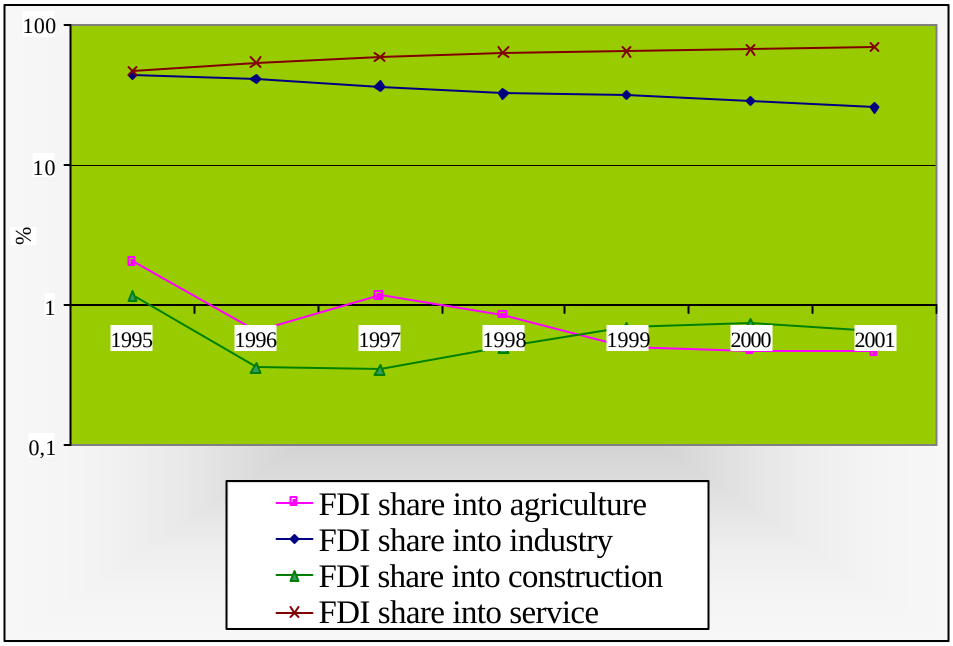

FIG. 2: FDI STRUCTURE BY MAIN SECTORS OF LITHUANIAN ECONOMY IN 1995-2001, %

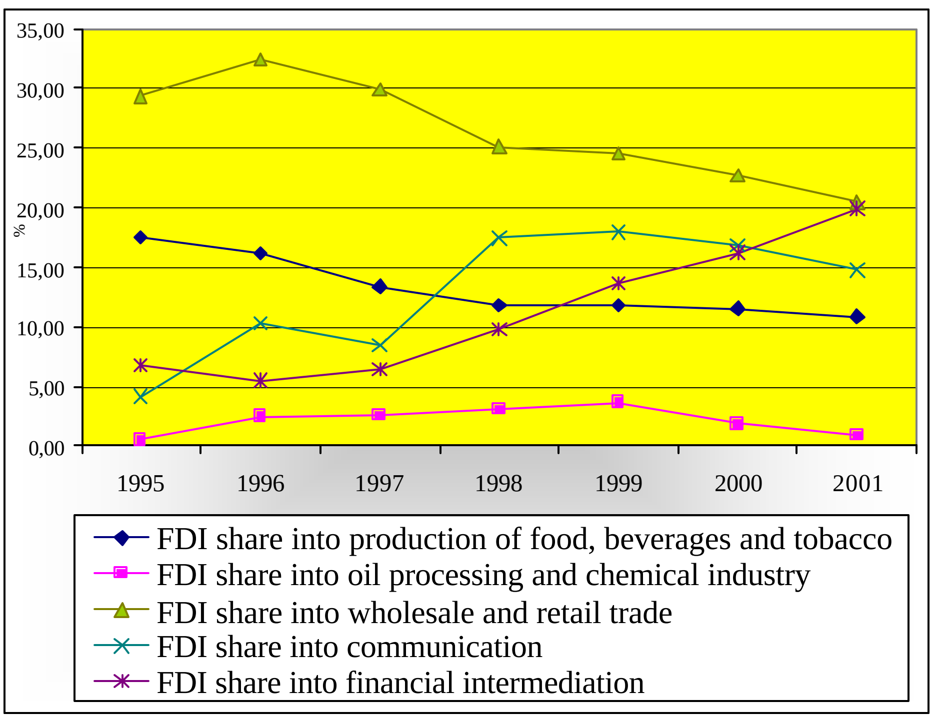

FIG. 3: FDI PERCENTAGE DISTRIBUTION AMONG THE MAJOR TYPES OF LITHUANIA ECONOMIC ACTIVITIES.

Inflows of FDI into industry sector in 1995-2001, in contrary, diminished from 44.13 to 28.0%. Foreign investors expressed interest in food, especially milk, processing, electronics, electrotechnics, light, chemical and oil processing industries. Nevertheless, the major part of investments in this sector has been directed into food processing, while interest in other activities was rather vague (FIG. 3).

As concerns such important for Lithuania sectors of economy as agriculture and construction, they, alas, as it has been shown in FIG. 1, attracted comparatively small capital inflows: share of FDI to each sector during period of 1995-2001fluctuated about 1%.

Agricultural sector historically has played very important role in Lithuanian economy. Now it comprises only 6% of GDP, but in this sector more than 21% of labor force is engaged. Hence, obvious low productivity of agricultural sector remains an urgent issue. Lack of interest from the side of foreign investors means that Lithuanian situation continue to be quite complicated and have to be improved by engaging local scare resources. Joining EU with all restrictions and regulations and high competitiveness in agricultural sector even more sharpens question of dealing with unproductive sector.

Analysis of composition of capital inflows of foreign capital showed that it doesn't correspond to composition of GDP. That means that FDI finally conditions restructuring of national economy. Tendencies of GDP restructuring (FIG. 4) in principle correspond to FDI dynamics what lets look at globalization processes as one of the main factor determining shifts in composition of national economy.

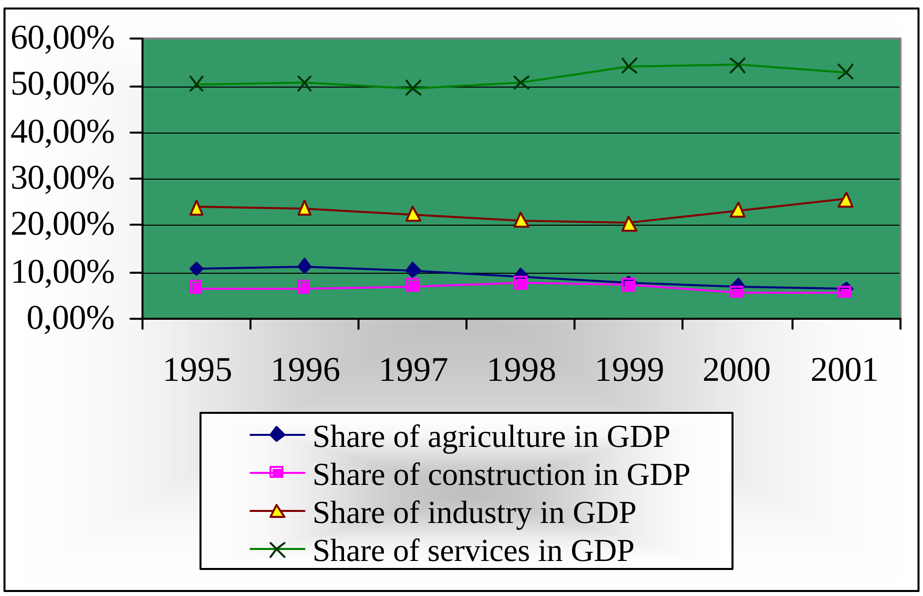

FIG. 4: DYNAMICS OF GDP PERCENTAGE DISTRIBUTION ON ECONOMIC ACTIVITIES DURING 1995-2001

The question, how globalization of separate sectors of economy impacts growth of general welfare of host country, remains key target of presented investigation. Below we present quantitative evaluation of influence of separate inflows of FDI on GDP growth and comparison of FDI and GDP structure, what lets to identify sectors in which foreign capital reached the highest level of penetration.

Quantitative evaluation of FDI efficiency

Quantitative evaluation of impact of separate foreign capital inflows on growth of national economy is very important as results would let to reveal certain cases and circumstances in which globalization represents threat to growth of national economy, and therefore should be prevented rather than stimulated by local government.

We repeatedly emphasize that, despite the majority of politicians and economists point to the positive sides of globalization, it doesn't mean, as it has been shown in scientific literature review, that each capital inflow finally stimulate economic growth. Our investigation tends to identify how FDI structure conditioned by objective factors (such as costs of production, level of consumption) and subjective ones (economical policy) affects GDP. Strength and direction of relationship between FDI structure and GDP would present direct answer to the question about efficiency of FDI directed to the different sectors of economy.

Method of correlation-regression analysis has been chosen for quantitative evaluation of FDI efficiency. Application of it lets to determine type of relationship between GDP and FDI flows into separate sectors of economy. Value of correlation coefficient nearing to 1 indicates that relationship between variables is strong, and sign of correlation coefficient – negative or positive – shows if, in our case, considered FDI flows negatively or positively effect economic growth. Data used for calculations and results presented in Appendix 2.

At the first stage of economic interpretation of calculation results lets concentrate on relationship between FDI into main sectors of Lithuanian economy (FIG. 2) and GDP. Correlation coefficient between FDI share to agriculture and GDP is negative (-0.81) and insignificant. That lets to state that specific and unfavorable business environment conditioned low and, even more, diminishing share of FDI (during period 1995-2001 it diminished from 2.06 to 0.47%), and contraction of this sector (in 1995-2001 sector contracted from 10.7 to 6.9%) . Hence, conclusion is that FDI to agriculture in Lithuanian case doesn't affect properly growth of GDP. Very similar interrelation between FDI to construction and GDP was found: here correlation coefficient also is negative and insignificant (it equals to -0.37).

Considering insignificant values of correlation coefficients between FDI share to agriculture and construction, in the further analysis we will put emphasis on FDI into services and industry, which in 2001 both together comprised 95% of total amount of foreign capital inflows. Interrelationship between FDI into those sectors and GDP is strong and significant: correlation coefficient between FDI share into services and FDI is equal to 0.99, and between FDI to industry and GDP accordingly equals to -0.814.

Hence, application of mathematical method confirmed theoretical premise about controversial impact of globalization of separate sectors on economical growth. In our case we received negative relationship between FDI share directed to industry and GDP, what indicated that globalization of industry sector retards development of economy. This aspect we will scrutinize thoroughly below.

A multidimensional linear equation lets to evaluate quantitatively impact of FDI shares directed to services and industry on GDP growth (determination coefficient of the equation 99%, what confirms reliability of calculations):

$$GDP = -23\,217{,}08 - 31{,}27 \times X_1 + 1\,044{,}57 \times X_{2;}$$

here: X_1 – FDI share into industry; X_2 – FDI share into services

Presented equation indicates that FDI distribution between sectors of economy plays quite important role in stimulation of GDP growth. The following comments could be brought. Positive strong relationship between share of FDI into service sector and GDP could be conditioned by increasing inflows of capital into this sector. Now it accumulates 69.0% of all FDI, what contributes to development of the sector and increasing share it comprises in GDP (now service share in GDP reached 54.3%). Generalizing we can conclude, that globalization of service sector is efficient from the point of view of host economy. Converse result characterizing impact of FDI share into industry on GDP could be partially caused by contraction tendencies of industry sector (during period 1995-2001 share of industry in GDP fluctuated from 23.9 to 25.6%, but in year 1999 it contracted up to 20.4%). Contraction of industry sector could be due displacement of local firms out of the market by foreign players or due to globalization processes of monopolistic firms, what objectively don't properly contribute to growth of GDP.

Evaluation of globalization efficiency in service and industry sectors should be done taking into account variety of activities, which have been embraced by considered sectors. Hence, the final conclusions about efficiency of separate inflows of foreign capital could be drawn only after scrutinizing relationships between FDI into those partial activities and GDP. Further analysis would involve two steps. At first, determination of relationship type between GDP and FDI shares into separate service activities would be done, and, the second, the same between

GDP and FDI into main industry branches would be repeated. Interpretation of the results would provide quite accurate evaluation of different facets of globalization.

We will concentrate on activities, which attracted the most significant capital inflows. In service sector the following ones could be distinguished: wholesale and retail trade (20.4% of FDI), financial intermediation (19.9% of FDI), and communication (14.8% of FDI). Statistical data on FDI distribution according economical activities presented in Appendix 2. Using the data pair correlation coefficients have been determined. However, Student coefficients signalized that FDI share taken separately into each considered activity doesn't affect GDP. Application of multidimensional correlation analysis let to receive linear equation showing impact of all service activities (even including not very significant ones) on economical development:

$$GDP = 1\,203\,127{,}74 - 34\,741{,}80 \times X_1 + 47\,5482{,}26 \times X_2 - 122\,875{,}01 \times X_3 - 83\,112{,}72 \times X_4 + 58\,419{,}61 \times X_5 - 41\,301{,}91 * X_6 - 475\,433{,}89 \times X_7$$

here: X_1 – FDI share into wholesale and retail trade;
X_2 – FDI share into hotel and restaurant activity;
X_3 – FDI share into transportation activity;
X_4 – FDI share into communication;
X_5 – FDI share into financial intermediation;
X_6 – FDI share into real estate;
X_7 – FDI share into education, health care , leisure and culture.

Presented multidimensional correlation equation enabled to reveal quite controversial from the superficial sight relationships. According the equation, relationship between FDI share directed into trade and GDP is negative, what could seem hardly possible. Nevertheless, closer look into considered activity provides appropriate explanation to the negative relationship. Share of trade in GDP is quite significant, but it have been diminishing: e.g. while in 1995 it comprised 16.3% of GDP, in 2001 share of trade contracted to 13.9% of GDP. Despite that this activity attracts quite big share of foreign capital inflows (in year 2001 up to 20.4%), attractiveness of it seems to be decreasing: in 1995 trade attracted 29.4% of FDI, while in 2001 accordingly 20.4%). Specifics of Lithuania suggest the following interpretation. FDI have reached such "saturation" of activity, which due to limited purchasing capacity makes further investment economically inefficient. Instead of increase in volume of sales additional investment started to lead only to redistribution of existing market share and to displacement of comparatively weaker firms. Hence, increase in FDI share wouldn't mean increase in GDP. FDI into trade activity diminishes, GDP, in general, grows, what conditions negative relationship between FDI into trade and GDP. Listed above arguments leads to a conclusion that here foreign capital reached high concentration and replaced local players.

Investigation also indicates negative relationship between GDP and FDI share into communication. Contrary than in trade activity, FDI share during considered period has been increasing and, at superficial glance, should positively impact GDP growth. Negative relationship could be caused by FDI, which had come via privatization of very important object for Lithuania – Lithuanian Telecom. Monopolistic position of privatized Telecom conditioned favorable uncompetitive situation in providing of fixed telecommunication service. It is notorious, that regulation of public monopoly is comparatively easier task than regulation of private monopoly. Hence, privatized Telecom, being private monopoly considerably increased prices, what, in its turn, caused some loss of consumers and decrease in volume of services provided, but, at the same time Telecom's revenues haven't diminished. In this case globalization in principle started to retard development of all sector of communication. This tendency of slowing down of development has been partially neutralized by sharp increase in demand of mobile communication [6]. Finally, we need to admit that Lithuanian case of globalization of telecommunication sector confirms theory about certain jeopardy to host country from the side of multinationals located in protected markets.

Notable, that some negative tendencies, traced in activity of Lithuanian Telecom, share of whole communication sector in GDP has been growing, and in 1998-2001 increased from 8.5 up 11.1%. Growth of sector has been reached due to increasing of activity scale of such foreign capital mobile companies as Omnitel, Bite GSM, and Tele-2: e.g. revenue of Omnitel during only year 2001 increased by 44.4%, Bite GSM managed to grow almost at the same extent (Lithuanian Bank, 2001). Growth in sales and constantly decreasing prices witness, that competitive environment in mobile telecommunication activity leads to increase of efficiency. Hence, we encountered situation when different capital flows into the same – telecommunication – sector of activity controversially impact development of national economy. Foreign capital flows directed into Lithuanian Telecom exceeded all other FDI into sector, what, finally determined negative impact of FDI share in communication on GDP.

Results of presented above multidimensional correlation equation indicate that FDI share into financial intermediation initiates development of this branch and contributes to GDP growth. It is peculiar, that foreign capital into the sector flew through different channels, among which privatization wasn't prevailing one. In 2001 Lithuanian Savings Bank was privatized. Differently, compared to Lithuanian Telecom, this bank didn't occupy monopolistic positions and its financial results were far from the leading banks. Even more, after privatization in result of reevaluation of material assets expenses increased by 85.5 million litas, what indicated that Lithuanian Savings Bank actually worked at a loss [6]. Hence, inflow of foreign capital through privatization in this sector didn't provide favorable conditions for investors. Additional FDI came to Vilnius Bank and Hansa Bank (previous Lithuanian Savings Bank) through channels not related to privatization. Financial intermediation sector started slightly to grow in year 2000. The growth was caused such factors as globalization and increase in demand in services of insurance companies due to introduction of compulsory civil insurance of cars. Nevertheless, globalization in sector of financial intermediation played the most important role in strengthening of key players and contributed to development of national economy.

Close look into globalization of service sector revealed that, despite, FDI share into services, in general, initiates development of national economy, separate capital flows retard economic growth of Lithuania. The most positive effect has foreign investments into financial intermediation, and the most negative effect have been traced in sphere of communication.

The following step of analysis will involve analogical determination of relationship type between GDP and FDI shares into main industry branches. Interpretation of the results would provide evaluation of different aspects of globalization in industry of Lithuania.

For detail analysis have been chosen those branches of industry, which, from the one side, attracted the major share of FDI, and, from the other side, have been considered as being of prime importance for Lithuanian economy. Received, and selected according Student coefficient (Appendix 2), correlation coefficients indicated that GDP is mostly effected by globalization of following branches of industry: processing of food, refining of oil and chemical industry, production of rubber plastic items, production of electrical and optical equipment. The extent and direction of interrelation between FDI share into listed activities and GDP is presented by received multidimensional correlation equation (determination coefficient 99%, what means that equation is significant:

$$GDP = 79\,566.68 - 2\,144.11 \times X_1 - 598.20 \times X_2 - 4\,666.23 \times X_3 - 1\,488.17 \times X_4$$

Here:

X_1 – FDI share into food processing industry;
X_2 – FDI share into oil refining and chemical industry;
X_3 – FDI share into production of rubber and plastic items;
X_4 – FDI share into production of electrical and optical equipment.

Calculations verify that globalization of industry don't initiate growth of economy enough, despite this sector of economy attracts significant share of FDI. Meanwhile, statistical data indicate recovery of food processing and other industries as increase of productivity and volumes of production were recorded [3]. Negative impact on economic development of country obviously had losses of such privatized strategic object as Mazeikiu Oil Refinery, which during period 1998-1999 increased from 32 272 thousand litas to 134 552 thousand litas. That confirms that globalization of monopolies, especially retard economic growth.

Investigation showed that globalization process of monopolies in Lithuania take place mainly through privatization. Privatization policy directed to so called "strategic investors" in principle conditions further restriction of competition in industries characterized by high concentration and big barriers of entry. Later on privatized enterprises enjoy favorable business conditions and aren't orientated enough to increasing of efficiency. Hence, government policy in field of regulation of globalization processes should put emphases on complex of economic tools making "green field" investments more attracting for foreign investors.

Evaluation of globalization process would be more thorough if FDI impact on restructuring of economy was taken into account. Hence, below globalization level of separate branches of economy will be scrutinized.

Impact of FDI on restructuring of Lithuanian economy

Impact of globalization on Lithuanian economy could be analyzed from another point of view. Comparison of FDI distribution between various sectors of economics and economical activities, from the one side, and GDP structure, from the other side, would let to indicate main directions of restructuring of national economy conditioned by globalization processes. We propose to perform the comparison by calculation ratio of percentage share of FDI directed into certain activity and percentage share of GDP generated by considered activity. If calculated ratio is greater than 1 that means, that appropriate activity attracts comparatively more foreign capital flows and, therefore, is more saturated by foreign capital. If globalization of considered sector, according presented above analysis, positively impacts GDP, then in the future the sector will be developed more rapidly. In FIG. 5 dynamics of ratio reflecting comparison of FDI and GDP structure is presented.

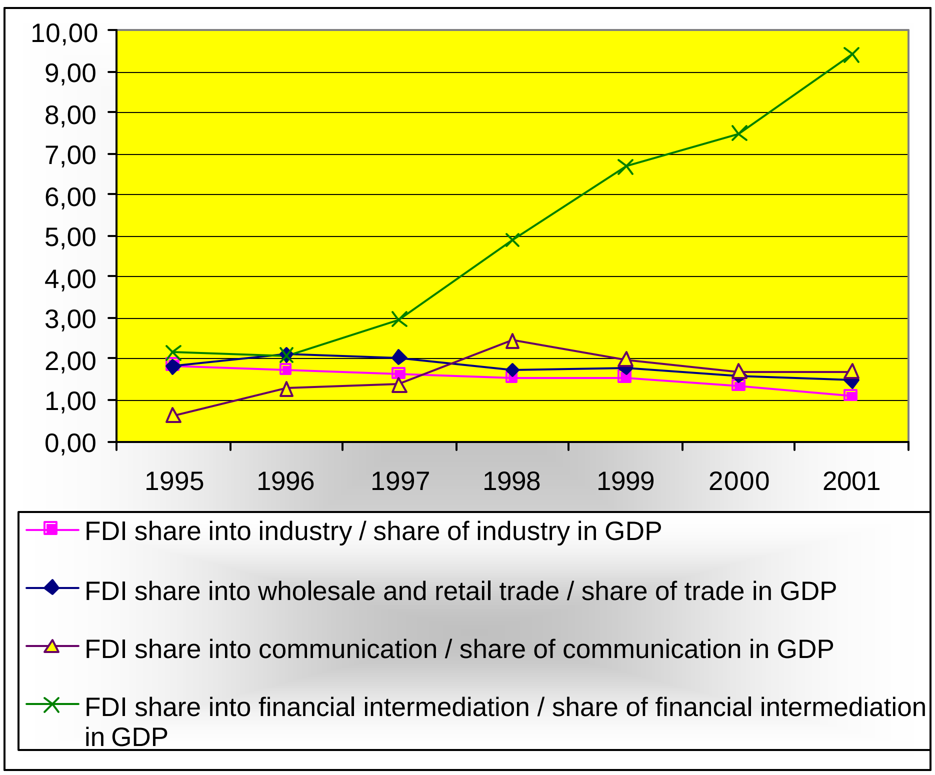

FIG. 5: DYNAMICS OF RATIO REFLECTING COMPARISON OF FDI AND GDP STRUCTURE DURING 1995-2001

The highest values of ratio were recorded in such activities as trade, industry and, especially, financial intermediation. Considering results of performed analysis we can expect that globalization processes will especially condition expansion of financial intermediation sector.

Probability that economy will be restructured towards trade and industry is treated as being quite insignificant as doubtful impact of FDI into those sectors on GDP growth has been determined.

Analysis of globalization processes in transition countries should involve especial emphasis on privatization processes. Pure fact of privatization couldn't be treated nor positively neither negatively. Meanwhile, occupation of monopolistic position by foreign investor doesn't lead to increase of efficiency and, as investigation show, finally negatively impact development of host economy.

Basing on poll of the biggest firms of foreign capital (Appendix 3) performed by Institute of Free Market Economy (The biggest investors) analysis of FDI sources has been done (FIG. 6).

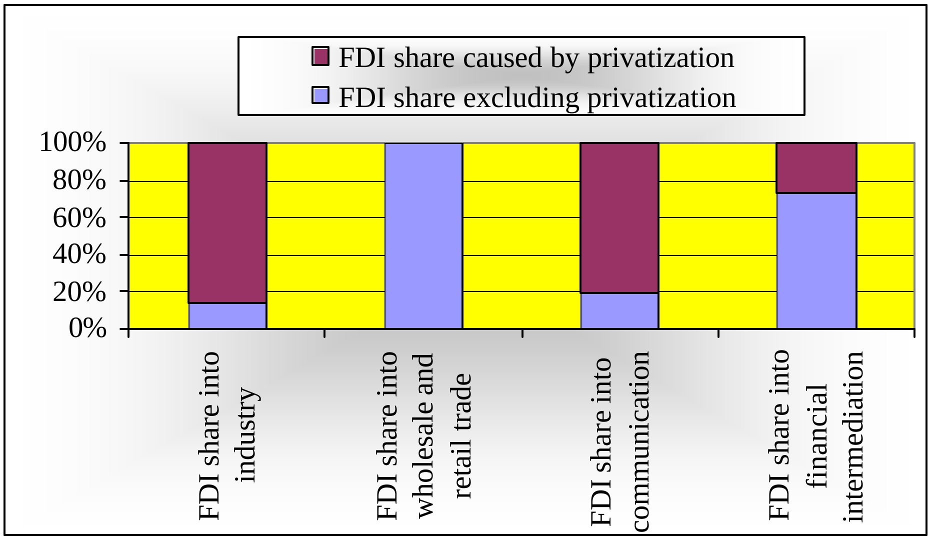

FIG. 6: SOURCES OF FDI INTO MAIN ECONOMIC ACTIVITIES

Results of current analysis indicate that in those sectors, in which significant share of FDI came via privatization, the most probable outcome of globalization is negative (in Lithuania in two out of three cases, where privatization played important role – in industry and communication sector – globalization results have been evaluated as negative). Foreign capital inflows reached country through other channels better impact growth of national economy.

Conclusion

Review of economical literature leads to conclusions that impact of FDI on development of economy of host country could be different and, even, quite controversial. In one case globalization can initiate growth of GDP through increase in quality and quantity of goods produced and services provided. It conditions spillover of knowledge, technologies experience to local companies, what enable them to survive even in environment of increased competition. In another case, globalization in sectors with high barriers of entry can enjoy favorable business conditions, extract rent and replace local economical entities out of market.

Performed economical analysis revealed that in Lithuania globalization of service sector positively impact economical growth, while globalization of industry sector doesn't.

Investigation has led to corollary that positive and negative impact of globalization is concurrent. Some inflows of foreign capital into the same sector of economy can be efficient from the point of view of host country, and some not. In transition countries, negative result of globalization most probably will be traced in privatized monopolies.

Generalizing Lithuanian case it should be stated that the highest level of globalization has been determined in trade, financial intermediation and industry. In some cases replacement of local firms took place, what confirms theoretical premises about malign impact of globalization.

Globalization process effects restructuring of national economy. Considering results of performed analysis we can expect that in the future sector of financial intermediation will expand significantly.

Despite overall effect of globalization is positive, government of transition country should more responsibly form privatization policy and put more emphasis on "green field" investments.

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Contact the author for a list of references.

Appendix 1

GDP structure by sectors of economy in 1995–2001

Year	Agriculture, %	Construction, %	Industry, %	Wholesale and retail trade, %	Hotels and restaurants, %	Transportation and communication, %	Financial intermediation, %	Real estate activity, %	Public administration, education, social insurance, health care etc., %	Other communal activity, %	Activity of households hiring labor force, %
1995	10,74	6,50	23,95	16,26	1,45	8,60	3,12	6,53	12,12	2,36	0,00
1996	11,25	6,51	23,73	15,43	1,55	8,74	2,30	7,03	12,86	2,32	0,00
1997	10,47	6,90	22,49	14,73	1,57	8,59	2,17	6,43	13,39	2,65	0,02
1998	9,09	7,57	21,10	14,44	1,27	8,50	2,01	6,81	15,03	2,63	0,02
1999	7,47	7,09	20,41	13,76	1,36	10,21	2,04	7,83	16,10	2,91	0,03
2000	6,99	5,51	23,32	14,21	1,25	11,04	2,16	7,76	15,39	2,69	0,03
2001	6,32	5,51	25,62	13,88	1,20	11,08	2,11	7,28	14,58	2,77	0,04

Appendix 2, part 1

Quantitative evaluation of relationship between FDI shares into separate economical activities and GDP

Year	GDP, millions litas	FDI share into agriculture, %	FDI share into construction, %	**FDI share into industry sector, %**	FDI share into production of food, beverages and tobacco, %	FDI share into textile, fur and leather industry, %	FDI share into wood processing, paper production and publishing, %	FDI share into oil processing and chemical industry, %	FDI share into production of rubber and plastic items, %	FDI share into production of metal constructions, %	FDI share into production of electrical and optical equipment, %	FDI share into production of means of transportation, %
1995	24102,80	2,06	1,18	44,13	17,50	6,47	3,46	0,47	2,50	0,58	4,06	1,22
1996	31568,90	0,66	0,36	41,17	16,14	7,02	4,19	2,46	1,48	0,50	3,38	3,14
1997	38340,30	1,18	0,36	36,65	13,36	4,12	2,76	2,58	1,36	0,37	3,00	4,83
1998	42990,00	0,86	0,50	32,41	11,76	4,81	2,42	3,04	1,38	0,44	2,05	3,35
1999	42654,60	0,51	0,70	31,82	11,80	4,33	2,30	3,67	1,17	0,43	2,71	2,73
2000	45147,60	0,48	0,75	31,31	11,54	4,67	2,49	1,83	1,14	0,50	2,27	2,06
2001	47958,30	0,47	0,65	28,14	10,85	4,05	2,30	0,87	1,01	0,60	2,05	1,42
Coefficient of pair correlation analysis (r)		-0,814008	-0,373	-0,9875	-0,9898	-0,83392957	-0,82318606	0,311672	-0,91471	-0,1698951	-0,96392	0,07394
Dispersion		0,3884403	0,6204	0,1052	0,09529	0,369058303	0,37969183	0,63543	0,27025	0,6590183	0,178009	0,66691
Ratio of coefficient of pair correlation to dispersion		2,0955802	0,6017	9,38756	10,3876	2,259614712	2,16803733	0,490489	3,38465	0,2578003	5,415023	0,11087
Student criterion												**2,77645**

Appendix 2, part 2

Year	GDP, millions litas	FDI share into production of furniture, %	**FDI share into service sector, %**	FDI share into wholesale and retail trade, %	FDI share into hotels and restaurants, %	FDI share into transportation activity, %	FDI share into communication, %	FDI share into financial intermediation, %	FDI share into real estate activity, %	FDI share into public administration, education, social insurance, health care etc., %	FDI share into leisure and culture, %
1995	24102,80	5,79	47,95	29,35	1,85	1,30	4,14	6,74	1,77	1,25	1,56
1996	31568,90	0,99	54,87	32,50	2,38	0,89	10,29	5,45	1,73	0,71	0,92
1997	38340,30	0,32	57,63	29,91	3,93	3,34	8,45	6,42	4,41	0,51	0,66
1998	42990,00	0,22	62,31	25,10	1,87	3,43	17,43	9,84	3,82	0,45	0,37
1999	42654,60	0,28	64,53	24,53	2,53	2,43	17,94	13,65	2,58	0,34	0,53
2000	45147,60	0,34	63,64	22,72	2,29	1,87	16,88	16,22	2,70	0,32	0,63
2001	47958,30	0,34	66,49	20,43	2,12	4,00	14,75	19,89	4,27	0,24	0,80
Coefficient of pair correlation analysis (r)		-0,814008	-0,836	0,98392	-0,8217	0,070098	0,714579	0,8609	0,8023021	0,668255	-0,9689
Dispersion		0,3884403	0,3665	0,11945	0,38113	0,667095	0,46782	0,3403	0,3991832	0,497497	0,16543
Ratio of coefficient of pair correlation to dispersion		2,0955802	0,6222	8,23704	2,15598	0,10508	1,527464	2,5298	2,0098594	1,343234	5,85715
Student criterion											**2,77645**

Appendix 3

The biggest foreign investors in Lithuania

No.	The biggest investors in Lithuania	Country	Object	Economical activities	mln. €
1	Amber Teleholdings Consortium (Telia/Sonera)	Sweden / Finland	Lietuvos Telekomas	Telecommunications	835
2	SEB-Skandinaviska Enskilda Banken AB	Sweden	Vilniaus Bankas	Banking	192
3	TDC (Tele Danmark A/S)	Denmark	Bite GSM	Telecommunications	151
4	Philip Morris International	USA	Philip Morris Lietuva	Tobacco Products	84
5	Carlsberg Breweries A/S; Baltic Beverages Holding	Sweden/ Finland/ Denmark	Švyturys and Utena	Brewery	78
6	Den Norske Stats Oljeselskap	Norway	Lietuva Statoil	Petroleum Products	61
7	Hansapank A/S	Estonia	Hansabankas	Banking	59
8	Vattenfall A/S	Sweden	Lietuvos Energija	Energy Production and Supply	57
9	DFDS Tor Line A/S	Denmark	Lithuanian Shipping Company	Sea Transport	125
10	Hansapank A/S	Estonia	LTB	Banking	86
11	Ruhrgas & E.ON Energie consortium	Germany	Lietuvos Dujos	Natural Gas	63
12	Bryggerigruppen (The Danish Brewery Group)	Denmark	Kalnapilis	Brewery	39
13	Dansico Sugar A/S	Denmark	Sugar Factories	Sugar Production	39
14	Amber Mobile Teleholding AB; Motorola; Private Persons	Sweden/ Finland/ USA	Omnitel	Telecommunications	38
15	The Coca-Cola Company	USA	The Coca-Cola Bottlers Lietuva	Soft Drinks	36
16	Kraft Foods International	USA	Kraft Foods Lietuva	Confectionary & Snacks	36
17	Tele 2 AB	Sweden	Tele 2	Telecommunications	35
18	Mars Inc.	USA	Masterfoods Lietuva	Pet Food	31
19	Codan Insurance Ltd., A/S	Denmark	Lietuvos Draudimas	Insurance	31
20	AS Hansa Liising	Estonia	Hanza Lizingas	Financial Services	30
21	Euro Oil Invest S.A.	Luxembourg	Lukoil Baltija	Petroleum Products	29
22	Neste OY	Finland	Neste Lietuva	Petroleum Products	29
23	Siemens Yazaki Wiring Technologies GmbH	Germany / Japan	Baltijos Automobiliø Technika	Electronics	25
24	Shell Overseas Holdings Limited	Great Britain / Netherlands	Shell Lietuva	Petroleum Products	23
25	Partek Insulation; Finnfund; NEFCO	Sweden / Finland	Partek Paroc	Construction Materials	23
26	Farimex S.A., Profilo Holdings	Switzerland / Turkey	Ekranas	Electronics	21
27	Odense Steel Shipyard Ltd	Denmark	Baltijos Laivø Statykla	Ship Building	21
28	Baltic Fund One LT	USA	Baltic Fund Securities	Financial intermediation	21
29	NORD / LB (Norddeutsche Landesbank Girozentrale)	Germany	LŽUB	Banking	40
30	Osman Trading AB; Woodison Trading AB; Ferrous Investment Ltd.; Duboil Ltd.	Sweden / Ireland / Great Britain	Klaipedos Nafta	Oil Terminal	19
31	Tuch Fabrik Wilhelm Becker	Germany	Eurotextil	Textiles	17
32	Svenska Petroleum Exploration AB	Sweden	Genciu Nafta	Oil Extraction	17
33	AGA AB	Sweden	AGA	Trade in Gas	17
34	Marzotto s.p.a.	Italy	Liteksas	Textiles	13
35	Petrol Holding A/S	Norway	Pemco Kuras	Oil lubricants	13
36	Danish Brewery Group	Denmark	Vilniaus Tauras	Brewery	12

Firms in a Regional Financial System: Asymmetries, Globalization, and New Financial Instruments. The Case of North-West of Italy

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Abstract

The Small and Medium Enterprises (SMEs) despite having great potential and flexibility, are still subject to extensive limitations in terms of financial resources: in fact, their size is not often able to sustain and reach the limit threshold to invest in innovation and R&D.

The last two decades have witnessed a strengthening awareness of the SMEs' contribution to production, consumption, and transferal of technological innovation. In Europe there are around 2,000,000 of SMEs (a quarter of which are in Italy); of these, only 1-2% are strictly producers of technological innovation, but a considerable 85% are buyers/users of technology to varying degrees and 10-15% are users that would like to produce it internally, but do not have the sufficient resources to do so. The role carried out by the financial system becomes consequently more and more important.

The aim of this work is to analyze the role carried out by a local financial system, which in the North West of Italy (Piedmont), in supporting the SMEs of its region. Specifically, it will analyze the evolution of the SMEs financial requirements and of the financial services supply in the region. Also, the paper will look into the debts structure of the SMEs. Moreover, the analysis will include the different kinds of financial relationships between the banks and the SMEs systems in the region, as well the possible role of venture capital and new financial operators in support of their stock capital.

1. The Evolution of the SMEs Financial Requirements in the New International Competitive Scenario

In the age of globalisation, enterprise competitiveness amounts to four main key factors: technologies, entrepreneurship, financial and institutional factors. Modern information technologies lower the entry barrier to global markets, giving SMEs a new role; but technology is not enough if it is not supported by finance, which plays a basic role in determining the switch from local enterprise to global one. In the United States, digital economy is based on a critical multitude of small and medium enterprises and innovative-networked *start-ups.* Thanks to easy access to venture capital, these small companies can rapidly become *leading* global enterprises in their industry.

Issues concerning structure of capital and re-allocation of ownership and control are of paramount importance for SMEs, because they are directly connected to the processes of accumulation and growth, and can therefore help overcome the chronic difficulties linked with the high level of borrowing characterising Italian SMEs. Dynamic SMEs on the real level and in terms of exports, but not up to times from the financial point of view, are facing increasing problems that concern the challenges represented by the globalisation of markets and the European single currency.

The globalisation of financial markets is changing the structure of capital of companies, particularly of the medium-large ones, from the most industrialised countries. The level of capitalisation of American and British companies, traditionally high, is decreasing and debt is being discovered, while European companies, typically under-capitalised, show a growth in venture capital.

Anglo-Saxon financial systems are characterised by their focus on the market, whereas the European ones focus more on intermediation. This type of evolution apparently mostly reflects the need to manage savings, with a view of increasingly mobile international markets, managed by institutional investors pursuing the strategy of risk diversification. In this respect, the Italian financial system, historically bank-focused, is also starting to open to innovative financial instruments, such as *merchant banking*, *venture capital*, participation loans, and *project financing*, but access to this type of instruments for Italian SMEs is, as we shall see, still very limited.

Italian SMEs, having to face higher difficulties than big companies in finding financing sources, have been cut off from the new financial circuits and still resort to bank borrowing, especially short-term, and self-financing as main sources of fund-raising. The constant under-capitalisation of companies, particularly of SMEs, the lack of venture capital and the high level of borrowing – while in the past did not limit growth, also thanks to particularly favourable leverage conditions – are now, in an increasingly competitive international environment, a major constraint instead. On the other hand, in Italy, the crisis of the welfare state, the reduction of public debt and consequent fall in treasury bonds yield, together with the widespread trend towards family saving, seem to be favouring a strong development of new types of institutional investors such as closed-end and pension funds, of course providing accurate and effective action is taken by the legislator.

The following section will deal with the potential role of these new financial instruments in the support and development of SMEs, as well as the evolution and current status of the banking system and its relationships with SMEs, highlighting its strong and weak points, all particularly relating to the region of Piedmont, in the northwestern part of Italy.

2. Financial Offer in Italy: the Banking System

In the 90's the Italian banking system underwent a thorough process of transformation and concentration, mostly driven by the liberalisation of banking activities, the integration of markets and the subsequent increased competition among brokers; at the same time, public presence in the ownership of banks was reduced (from 68% in 1992 to around 10% at present). From 1998, it has been also permitted to increase the offer of products for savings management, giving brokers higher autonomy in terms of organisational choices.

All this resulted, between 1990 and 2001, in 386 mergers or incorporations among banks and 166 acquisitions of the stock-holding majority, which reduced the number of banks in Italy from 1,061 to 769. The availability of banking services, however, has increased, thanks to the substantial rise in the number of branches, which in the same period has risen from 16,500 to 29,200 (+76%); in Piedmont alone there are 2,439, with 54, 8% of municipalities having at least one bank

We are therefore witnessing a market which is concentrating more than what may seem; acquisitions, contrary to mergers, do not cause the disappearing of the acquired bank: yet, even though the number of banks does not decrease, the acquired local bank has in fact disappeared, having become part of the distribution network of the bigger group.

Within two years from now, the Italian banking system will complete the re-organisational stage of ownership, which has led to the concentration in four large groups with other forms of aggregation being constituted at their margins, including those of credit societies.

2.1 Structure and evolution of the banking system in Piedmont

The above-described changes and concentrations significantly affected the north-west of Italy too, and particularly the region of Piedmont with three of its main banks: the Banca Popolare di Novara, the Cassa di Risparmio di Torino and the Istituto Bancario San Paolo di Torino. Since June 2002, the Banca Popolare di Novara S.c.r.l. has merged with the Banca Popolare di Verona – Banco S. Geminiano e S. Prospero S.c.r.l., constituting the Banco Popolare di Verona e Novara S.c.r.l. The bank, after a period of activities mainly aimed at the large industrial and financial groups, has gone back to its traditional customers, made of families, professionals and small and medium enterprises.

The Cassa di Risparmio di Torino has instead become the part of the UniCredito Italiano, the biggest banking group in Italy as regards Stock Exchange capitalisation. Formed in '98 by the aggregation of Credito Italiano and Rolo Banca 1473 with Cariverona, Cassa di Risparmio di Torino and Cassamarca, in '99 the Group also incorporated the Cassa di Risparmio di Trento e Rovereto and the Cassa di Risparmio di Trieste. A multi-specialised business model was chosen, with strong international orientation and an organisational structure aimed at leveraging competitive advantages deriving from the rooting in typically local markets of the Casse di Risparmio, but through the joint management of the individual customer segments (*corporate, retail and private banking*).

The Istituto Bancario San Paolo di Torino, on the other hand, has merged with Imi in 1998, thus forming the San Paolo-Imi Group. The Group is strongly specialised in financial services for the *retail* customers, in managed saving and in *Corporate Banking* and *Investment Banking* activities. In May 2002 the company completed the merger with the Cardine group, which will allow the creation of the second largest banking group in terms of assets, behind IntesaBci and ahead of Unicredito.

Besides those concentrations there are still many small and medium credit societies and local banks with strong territorial connections, such as for instance the Banca Sella or the Banca del Piemonte.

Tab. 1 summarises the territorial distribution by administrative districts of Credit Institutions operating in Piedmont, divided by institutional groups. The district of Cuneo has the highest number of operating banks, 13 compared to the 10 of Turin (but not of branches), as well as the highest number of co-operative credit institutions, reflecting the local trend towards production.

TABLE 1 – DISTRIBUTION OF CREDIT INSTITUTIONS BY DISTRICTS AND INSTITUTIONAL BANKING GROUPS OPERATING IN PIEDMONT (*)

	Total		**Plc Banks**		**Credit societies**		**Co-op. credit banks**		**Foreign bank br.**		**Ind.-spec. Centr. ins.**	
DISTRICTS	**Banks**	**Branches**	**Banks**	**Branches**	**Banks**	**Branches**	**Banks**	**Branches**	**Banks**	**Branches**	**Banks**	**Branches**
Alessandria	3	276	2	270	-	5	1	1	-	-	-	-
Asti	1	147	1	136	-	4	-	7	-	-	-	-
Biella	2	127	2	125	-	2	-	-	-	-	-	-
Cuneo	13	458	5	359	-	1	8	98	-	-	-	-
Novara	1	192	1	153	-	39	-	-	-	-	-	-
Turin	10	1.023	9	972	-	31	1	16	-	3	-	1
Verbania	2	84	-	57	1	26	1	1	-	-	-	-
Vercelli	-	132	-	131	-	1	-	-	-	-	-	-
PIEDMONT	32	2.439	20	2.203	1	109	11	123	-	3	-	1

(*) Data: 30/06/2002. source Banca D'Italia

2.2 Relationships between SMEs and local banks: strong points and development prospects

Despite the above-mentioned processes of concentration of the financial system, in Piedmont there is still a comprehensive network of local banks, which have always had a privileged relationship with the SMEs in the region. The typical characters of these local banks can become towers of strength for the future too, especially if appropriately directed.

The main advantages characterising local banks in their relationship with SMEs typically are:

?? strong links with their customers and personalised relationships,

?? generally motivated staff,

?? fast decision-making,

?? in-depth knowledge of the production framework and of individual operators deriving from their territorial rooting and long-running business relationships. This element is very important because, while the large concentrations of banks normally imply the moving of decision-making centres to distant places, in small independent banks those in charge of decisions and long-term strategies live in the same areas, which will be affected by the decisions, made.

Anyway, these strong points are not sufficient to ensure by themselves the long-term success of local banks and their support of SMEs, within an environment that is much more competitive and rapidly changing than in the past.

However, the simultaneous presence of three new instruments, such as technology, globalisation and outsourcing, can allow, also in the financial field, to switch the focus from the critical variable constituted by the small size to a new key factor for success: the ability to manage complexity, in the case of SMEs particularly facilitated by their higher flexibility.

Technology nowadays allows applications which where unimaginable up to a few years ago; globalisation and technology together allow a small bank the distribution of the best existing products in the world, in the most diverse financial sectors, achieving the most accurate detail and reaching the smallest customer. Outsourcing, moreover, allows to delegate externally (possibly by setting up specialised companies, forming alliances with other small banks or companies of other industries) the activities requiring particularly big investments or different from the "*core business*".

Case studies are available on the effect of bank concentrations in two countries, Italy and United States, and show that banks, after the merger or acquisition, reduce the portfolio percentage invested in loans to companies of small size; it may therefore happen that big banks leave a growing space to the smaller ones, particularly in the support of SMEs.

The new strategies of big banks entail the creation of stand-alone *retail*, *private* and *corporate* departments and, as a strategic response to competition by big international banks, *corporate banking*. The *corporate banking* department manages relationships with medium enterprises according to a logic of *relationship banking* with high consultancy contents. The price of credit to *corporate* clients depends on a personalised *rating* assigned by the bank and by the profitability of the relationship with the client.

Small enterprises are instead assigned to *retail* departments with logic of *transactional banking*, characterised by multi-assignment, offer of standardised products, low consultancy contents. The price of *retail* credit depends on a mechanical *rating* (*scoring*) assigned by the bank according to product-based pricing policies and existence of collateral guaranties.

A possible way for local banks to respond to such a policy by the bigger ones may be based on maintaining a single distribution network and control over clients who are potentially overlooked by big banks (small business - advanced retail), which entails two types of challenge: maintaining an adequate personalisation of relationships, by strengthening the consultancy contents, and conforming pricing policies to "Basle2" (the new European financial rules from 2006), by introducing a reasonably-priced system of *internal rating*.

Most likely, the most critical aspects of *retail lending* after "Basle2" will be transferred on the Confidi; guaranties will probably have to absorb those risks which cannot be assessed analytically in a cost-effective way, and improve *rating* of *retail* portfolio through the reduction of loss in the event of insolvency.

2.3 Structure and features of the financial structure of SMEs in Piedmont

On the financial level, as regards the current situation, all data show a strong liquidity crisis for companies, particularly SMEs; this crisis is further worsened in Piedmont by the crisis of *Fiat* (the main Italian automotive company just located in Piedmont) and its side business, particularly for those companies which at the end of the 90's could not diversify their production and customers.

Data from the Central Bank of Italy (Banca D'Italia) for the June 2001 – June 2002 period confirms that the banking system of the region perfectly matches such difficult economical situation. In this period it shows both an increase in lending (that is, of indebtedness towards banks), rising from 80.43 to 80.897 billion Euros (+ 0.58%), and in rectified overdue payments (that is, of unpaid debts), rising from 2.286 to 2.38 billion Euros (from 38,873 to 39,346 in terms of number of beneficiaries) with a run-up in the second quarter of 2002.

The rise in lending by Piedmontese banks is even more remarkable (amounting to 19.34%) if credit granted to industry alone is considered, rising from 18.876 to 22.572 billion Euros; the increase is less substantial (+7.94%) if funds granted to companies for investment in machines and equipment are only considered, which however rose, in the same period, from 9.465 to 10.207 billion Euros, with a strong up-rise between April and June 2002 (5.043 billion Euros granted, compared to the 1.272 of the same quarter of 2001).

This type of investment, useful to the economic recovery of Piedmontese companies, is a first faint positive sign in a not too promising general frame, together with the increase by 6.86% of deposits in the banks of the region, risen from 38.56 to 41.209 billion Euros from June 2001 to June 2002.

The situation is also confirmed by the survey carried out by the Central Bank of Italy on the economic trend of the type of financing granted to meet the needs of Piedmontese industrial enterprises for current assets investments. According to these data self-financing has continued to be the main source in 2001 as well, covering

58% of the need, followed by short-term (18.3%) and mid-long-term (15.9%) bank debt, while recourse to the venture capital market was still very low (1.6%).

Among the few positive data there is the interest rate offered by Italian credit institutions, which showed a general decrease between 2001 and 2002, and Piedmont was among the regions with the lowest cost of money: both in 2001 and in 2002, however, it was Lombardy that reported the lowest interest rate for short-term financing (respectively 6.02% and 5.07%), while Piedmont established itself around 6.49% in 2001 and 6.08% in 2002. For mid- and long-term, the interest rates in 2002 go down to 5% in Piedmont and 4.67% in Lombardy.

In addition, a recent survey (Piccolaindustria Report - Unione Industriale di Torino, 2003) on 212 Piedmontese companies, 70% of which with less than 100 employees, has highlighted one of the effects of the crisis of the automotive industry in the region: 18% of the small enterprises analysed has suffered the reduction or writing off of bank loans, with average cuts of 54%; the 25% of them has shown an increase by more than one percentage point in cost of credit.

The difficult relationship with bank is more evident in companies whose sales in the automotive industry are higher than 10%. Half of the sample sells part of its production in the automotive industry and almost a third derives over 30% of its turnover from the automotive sector. Their relationship with the credit system is mostly characterised by short-term loans, amounting to 72.8% of the total. Guaranty consortiums on bank loans cover only in 11.8% of these reported cases.

Also according to the survey, indicators such as economic advantage (18.5%), reliability (8.2%), rapidity (16.9%), flexibility (13.3%), and professionalism ((18.4%) all influence the choice of banks (on average each company has lending relationships with three or four credit institutions). The quality of interpersonal relationships, however, prevails over all the above factors, as indicated by 22.1% of the sample.

The cut in loans has been explained by banks mainly with the crisis of the automotive industry, mentioned in 55% of cases. The rate paid decreases inversely proportionally with the size of the company, descending from 7.3% of small enterprises to 3.7% of the largest. In general, however, interest rates have gone up for almost a quarter of the companies, differently from what is indicated by the above-mentioned official data from the Central Bank of Italy, and small enterprises linked to the automotive induced business are mostly affected.

Credit institution has been already heavily hitting SMEs long before *Basle2* comes into force. In fact, credit rationing affects small and medium enterprises more heavily, and the availability of the banking system to grant credit to small and medium enterprises decreased significantly, going down to as much as one third. Credit granted to companies with up to 50 employees amounts to about 14% of the total. This percentage, though, goes down to 5% for handicraft enterprises and Piedmont equals the national average with 4.9%.

Several reasons are accountable for this difficult situation: the processes of concentration of the banking system have caused a decrease in the number of small local banks, favoured interlocutors of SMEs and craftsmen. Prospects concerning guaranty consortiums, such as the Confidi system, seem to be better. Data shows that the interest rate applied by banks in the event of cases supported by a Confidi reaches the level of the bigger customers. Without the guaranty consortiums, instead, entrepreneurs pay at least one third more for a loan. The level of insolvency, i.e. when loans are not paid back, also decreases significantly if a guaranty consortium (from 5.5% to 1.5%) supports the case. In Italy, there are 898 Confidi in total, 49 of which in Piedmont (5.5%), compared to the 108 of Lombardy, the 96 of Veneto or even more the 115 of Puglia. Despite the not so high number of organisations, in Piedmont the guaranty activity of the Confidi (Eurofidi and Unionfidi) in favour of SMEs is constantly growing, amounting to around 2.7 billion Euros in 2001 and further growing towards 3 billion Euros in 2002.

The regional administration, to counter liquidity crisis of companies, has implemented new actions, among which a *plafond* of 2.5 million Euros allocated by Eurofidi for SMEs of the automotive industry, in order to offer the Piedmontese banking system the necessary security to open credit lines. Furthermore, from the political point of view the region has required the institution of a guaranty fund of 50 million Euros by the Italian government, while for the regional financial law a special revolving fund of 15 billion Euros is being studied, also for the purpose of credit guaranty for SMEs of the automotive side business.

3. Alternative Ways to the Development of SMEs: the Potential Role of New Financial Instruments Supporting their Stock Capital

As described above, a fast evolution is taking place in the Italian financial market. The need for higher long-term allocation efficiency has led to, besides concentration processes, the introduction and spreading of new financial intermediaries for venture capital, which could become important for the future development of SMEs.

Investment in venture capital contributes to the development of the industrial system, by selecting companies with high growth rate and giving them the necessary means for development. The existence of operators who can offer mid-long term financial resources helps the companies find valid support in the most delicate stages of the life cycle (*start up*, development, M&A, etc.). More particularly, the companies to develop new products and new technologies, to expand liquid assets, to fund acquisitions, or to strengthen the financial structure of the company, can use such capital. *Private equity* can also be used to solve the problems connected with the ownership of an enterprise or with the generation transition aspect. Furthermore, it is the preferred instrument to carry out *buy out / buy in* operations by experienced managers.

The stable and continuous flows of resources guaranteed by these type of financial instruments can constitute the way to break the balance of a financial system that is too focused on financial brokers, whom Italian SMEs are inevitably linked to (because of the high levels of indebtedness) causing the switch to a more market-oriented financial system of Anglo-Saxon type. The advantages of this change could be significant for smaller enterprises, not only for the higher availability of sources of finance, which can help solve the problems of under-capitalization of companies, but also in terms of executive support to management and of reduction of information asymmetries, which small enterprises would benefit greatly from. According to the Anglo-Saxon terminology, new brokers are essentially divided into two broad categories:

- *Venture Capitalist*, if they mainly invest in companies in *seeding* and *start up* stage*;*
- *Private equity investor*, if they invest in companies at more advanced stages of their life cycle and can therefore help solve the many problems connected with the ownership structures and with *buy in* and *buy out* operations.

The type of investors currently active in Italy on venture capital investments (to this day still mainly favouring medium-large companies) are: banks, public operators, closed-end movables funds, pension funds, non-institutional *venture capital* initiatives, *business angels* and enterprise incubators. We shall now examine the role of some of them and the relative potential for support of SMES, both in general terms and as regards the Piedmontese situation.

Closed-end funds in Italy have only been regulated by Act no.344\1993 and will be able to play an increasingly important role for SMES, as they are characterised by a remarkable stability of collection, since shares can only be redeemed after a high number of years (max. 30). They can consequently allow long-term investments in movables that are difficult to liquidate such as shares of small not publicly traded companies. In Piedmont, as regards this, the *Sviluppo Nord Ovest* project is being implemented, to which the "*Nord Ovest*" closed-end fund will be connected; the following are taking part in it: Unicredito for 80%, Unione Industriale di Torino for 10% and Unionfidi Piemonte (which will provide security up to 60% of the value of the various investments and any capital loss in the event of unsuccessful operations) for the remaining share. The fund will provide 50 million Euros to be allocated for operations ranging from 500,000 to 3 million Euros in favour of innovative SMEs of the north-west of Italy, to be performed through the underwriting of their shares of capital increase or the participation to the issue of their convertible stock loans. 80% of the fund will serve the *private equity* for the funding of existing enterprises, while 20% will be destined to *venture capital* to support *start-ups* in the *high tech* industry.

San Paolo IMI, through San Paolo IMI Private Equity, is also developing the market of closed-end funds and, among these, one has already been scheduled to be specialised on SMEs of the north-west (Fondo Nord Ovest), following what has already been achieved with a closed-end fund for investments in small and medium enterprises in the south of Italy.

Another financial instrument with high potential is represented by **Pension funds** which are, among institutional investors, the most suitable to channel family saving (Italy, and Piedmont in particular, have one of the highest rates in family saving in Europe) towards venture capital. In countries where pension funds have enjoyed a widespread diffusion, they have actually played a major role in *venture capital* funding.

The saving gathered by them is of social security-contractual type (financial resources set aside and invested to guarantee workers future income through a capitalisation process), and therefore, it shows two significant features: stability of collection flows and long time of use, yielding the following advantages:

- It allows the investment in financial activities with high expected revenue but low level of liquidity;
- It can contribute in a qualified way to the management of participation companies;
- It allows portfolio diversification (also in *venture capital* activities) which becomes more efficient thanks to the lower information asymmetries.

Generally, however, pension funds only invest a small percentage in venture capital for companies, because they often lack the necessary skills in the choice of real investments. On the other hand, they indirectly invest in venture capital through closed-end funds and *venture capital* associations, who have the necessary expertise.

Pension funds instead invest in the various initiatives according to a purely financial view. A strong bond among pension funds, closed-end funds, *venture capital* companies and participation companies is thus established. The development of pension funds in Italy, however, is still drastically limited by fiscal problems, as an increase of their current limits of deducibility from income would be needed.

Pension funds could achieve a certain drive through a different way though. At present the TFR (Trattamento di Fine Rapporto – the severance indemnity) Fund acts for Italian companies, especially SMEs, as a form of stable and substantial "facilitated financing" (at the expense of workers). A heated economical-political debate is however taking place as regards replacing it through the development of pension funds and the capitalization of companies.

The possible elimination of the TFR fund would increase the recourse by companies to the much more burdensome bank debt, and pension funds could play a major role in avoiding financial crises for the smaller enterprises (where the TFR seems to have a higher impact on the composition of debt), which would certainly also be those that would face the bigger difficulties in finding alternative source of mid-long-term financing.

Only recently non-institutional *Venture Capital* companies have started operating in Italy, with a strong delay compared to other countries and the United States, where they have been the basis for the development of the *new economy*.

These companies can be generally divided into three categories:

?? *enterprise incubators*, supplying resources to new companies in *seeding* and *start up* stage; in Piedmont a few incubators are already active, such as the one at the Polytechnic of Turin and those connected to the Scientific and Technological Parks existing in the region;

?? *Business Angels*, consortiums of managers or entrepreneurs with deep knowledge of the industry they invest in, organised in networks (Business *Angel Networks*) allowing for the meeting of investors and entrepreneurs; they differ from *Venture Capitalists* as regards the sums granted, which normally do not exceed 250,000 Euros (thus making them particularly suitable for the smaller enterprises) and from incubators, because they also offer managerial support to the companies they fund. This reality is still quite rare in Piedmont, while it has instead found fertile ground in Lombardy;

?? The *Corporate Venture Capital* initiatives, still scarce in Italy and in Piedmont, put into effect by big companies interested in investing in new initiatives aimed at finding new markets in different industries.

After the halt in 2001, the Italian *venture capital* and *private equity* market has shown some signs of recovery. In 2002, 2,626 million Euros were invested by operators in Italy, amounting to a 20% increase compared to 2001. The number of operations instead has shrunk further, decreasing from 489 in 2001 (-24% compared to 2000) to 301 in 2002 (-38% compared to 2001). As far as the geographical distribution of investments is concerned, concerning the operations directed to Italian companies (amounting to 87% of the total), operators have indeed mainly focused on the north of the country (82%), but not on Piedmont yet; the highest levels of intervention have in fact been recorded in other Italian regions: Lombardy, Emilia Romagna and Friuli Venezia Giulia.

In Piedmont, however, *Buy out* activities are enjoying a good deal of fortune, thanks to big acquisitions made by institutional operators and to large investment funds towards already mature companies with good industrial projects, but suffering from financial problems: in 2002 the total amount was around 180 million Euros, as opposed to just over 28 million in 2001. These figures arise from big operations such as the acquisition of Teksid by a group of international investors, as well as from operations performed on Piedmontese SMEs such as for instance Sparco (by the Paneuropeo Argo Soditic Italia fund).

Conclusion

To conclude, it can be said that in an industrial system such as the Piedmontese one – suffering from a deep crisis of identity and liquidity and burdened with heavy debt, as well as inserted in a vice versa more and more competitive and innovative environment – the role the regional financial system plays is becoming even more decisive than in the past.

Following the important concentration processes of the banking system, new areas of support for local SMEs can be preserved or created from scratch thanks to two types of subjects: small and medium local banks and new investors in venture capital of companies. Local banks must learn to turn those that at first glance may now seem weak points- the smaller size, the deep territorial rooting and focus on local industries- into advantages. This is possible thanks to their higher flexibility and to the use of new technologies and outsourcing, as well as trying to cover quickly the areas left free or difficult to occupy by the big banks, particularly in the relationship with SMEs.

On the other hand, new institutional investors in stock capital of companies can be an alternative and/or parallel outlet to traditional instruments providing SMEs with long-term resources with low level of liquidity to help them overcome the *standstill*. Moreover, these resources can be helpful in reducing SMEs' level of indebtedness and the information asymmetries that almost invariantly characterise the relationship between SMEs and financial institutions, and achieving higher competitiveness at international level, through this course.

Italian SMEs have always had to come to terms with a scarcely distributed financial system, with strong information asymmetries and lacking intermediaries able to bring them closer to the new funding channels.

The banking system concentration processes of the last decade, which have had significant impact on the north-west (Piedmont) - although a reasonably good network of local banks and therefore closer to the needs of SMEs has been maintained – have however promoted the creation and/or specialization of new financial intermediaries: in particular pension funds, closed-end funds and *venture capital* companies. These instruments can be expected to play a decisive role in the process of modernisation and development of the Italian industrial system over the next few years, helping generate new opportunities also for the Piedmontese SMEs, thanks to a constantly increasing integration between the more traditional financial route to development and the new course of venture capital.

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The Application of Creativity in The Thinking of Managers and Entrepreneurs and The Possibilities for their Development under the Prevailing Conditions in The Czech Republic

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Abstract

This piece of research was devoted to the possibilities of developing the creative potentials of managers and the methods that it is possible to consider as having been the most effective in their training. It compared the Simulation and Case Study methods and traditional forms of preparation in the form of lectures and discussions in seminars. The outcomes indicate that most optimal form is that of a compromise, i.e. the rotation of all of the afore-mentioned methods, since each of them develops a differing aspect of the personality of a manager. What is important, however, is to develop not only their divergent, but also convergent forms of thinking (cogitation). The person concerned with the solution of this problem must come to a single concrete conclusion at the conclusion of each of the definite and pre-defined stages chosen.

Introduction

The term or concept "Creativity" is often used as a magic formula - which also serves as a form of alibi. It is a fashionable conceptual term that is currently much used (overused) and in vogue. For many, it is a conceptual term with a very universal form - and for that very reason, it is also difficult to delimit, define, and specify. It is universal in the sense that it is applied to a whole varied range of activities. Especially those who are professionally interested in this term and its underlying concept(s) have doubts and reservations about how to come to terms with this conceptual term, as well as how to precisely define it on a generalised level. Differing criteria hold true for the creativity of an artist, musician, or writer; and a completely different set are relevant to the work of a scientific research worker and for scientists than hold true for the endeavours of a manager, for example.

One should not forget that creativity is as individual as each individual, and manifests itself spontaneously and in all forms of activity. All that is necessary for it to appear is whether a person has a barrier-free space around themselves which allows them free rein to use it. It is therefore necessary to guide people to a point where they are not only able to exploit the potentials of their creativity, but concurrently to further develop them too.

Creativity is, without a shadow of a doubt, the most effective means for solving problems, to making activities more effective – and to discovering new, innovative approaches and opportunities in the market environment. It is a reservoir for the further development and evolution of society, since it represents an opportunity, which simply cannot be replaced by anything else. It all depends on whether such an activity is positively oriented. The ways and means for its more effective exploitation begin with its development and evolution in the pedagogical-educational processes from the earliest days of one's schooldays. It also continues in the course of the employment and work processes and within the overall framework of Lifelong Learning (Continuous Education). Managers further develop their own creativity, but also should support its development in their co-workers. They should know how to seek out the creative employees under them, how to retain them (in their posts), and how to further develop this creativity in their fellow employees.

A whole range of psychologists have interested themselves in the phenomena of "creativity in the working processes of managers and entrepreneurs" for a number of years. They have endeavoured to find correlations between a manager's work and an entrepreneur's activities and the factors governing or related to creativity. Let us mention a few of them in passing: B.G. Whiting, N. Lodge, E.P. Torrance, Winslow, Solomon, Fry, B. Gilad, M. Jurcová, W. Scharf, J. I. Reynolds, M. Pollick, I. Nueten, J. Culvenor, D. Else, M. Basadur…

The most significant condition for the further development of creative potential is one's genetic gift for a given branch and favourable conditions for their development in the periods of one's childhood and maturation. Later influences are not so significant – but this does not mean a latent creative potential cannot be awakened and developed. In Science, it is important that one gets into the right university, is granted access to research opportunities, and that one is granted sufficient time, material, and even social conditions for one's investigations, as well as the opportunity to be in constant contact with other researchers.

In an enterprise, it is necessary that one find a place where the fundamental underlying principle is a support of creativity, where the Top Management are willing to believe in creativity per se as a valid entity in their own endeavours and in those of their subordinates. Creativity is an expression of a whole complex of systems, which is an expression of the synergy arising out of a whole range of internal and external factors – and often, a single missing link may thwart the positive development of new thoughts, discoveries, and products.

The internal factors have a very singular structure, which often appears highly disorderly, like unintelligible chaos – but this is only because the whole structure is so complicated. Human creativity is expressed through contradictory polymorphism, extreme expressions, and an individual uniqueness. A creative person on the one hand may be more aggressive than the average person, but at the same time, and under certain conditions, even be cooperative. A complex creative personality exploits to a greater extent than is usual a wider palette of characteristics than is usual for the average person. For this very reason, a creative person may come across as an individual full of contradictions and extreme forms of expression. But this is only an expression of their greater potential, not their inconsistency.

Creative people have a lot in common with the type of person that K.G, Jung typified as "Mature Personalities". What is meant here is that the strengths of that personality strike one as if they were precisely the opposite, as if they were suppressed sides of that personality – which the average person usually denies about themselves, whether consciously or subconsciously. Thus, a very orderly and prim and proper person secretly desires to be spontaneous; a humble person longs to govern others; a closed (introvert) person yearns to be open (extrovert) - and on the contrary, the open (extrovert) person yearns for a meditative spirit and an empathic understanding of others...

Should such personality traits be suppressed however, the individual will remain unsatisfied and so frustrated. They guard themselves, in order not to drop out of their role, in order to respect all of the rules (written and unwritten) with which they have been confronted in the course of their lives. They often fight an internal battle with themselves, which is precisely what leads to their being average and to the fact that they are not spontaneous and thus cannot fully develop their own potentials.

A creative person is capable of experiencing both extremes with the same degree of intensity and without internal conflict.

A creative person abounds in physical energy, but at the same time, is capable of being still, calm and relaxed, or even passive. A creative person may be highly intelligent – but at the same time, naïve in some respects. They are capable of fantastic flights of fantasy – but on the other hand, of a down-to-earth realism. They are able to be open, while at the same time being closed – at its extreme even autistic. Within them are enjoined a mixture of humility and pride. They can be ambitious, competitive – but also willing to sacrifice themselves and to be cooperative. They are capable of being independent - but also of being conservative; passionate - and objective; sensitive and vulnerable – but they are also able to intensively experience the depths and heights of joy/happiness.

A creative approach is especially appropriate when resolving unstructured and strategic problems, i.e. crisis problems and situations.

Organisations which are successful, resolve their problems through a creative approach to the same. They are able to react to changing situations, are capable of innovation, in short – they are competitive. In the EU, less developed regions only chance to make an impression and place for themselves is through the development of the creative potential of their labour force, i.e. when they learn to guide this force towards this goal and to so train them in their schools and enterprises. It is essential that creativity be applied at all levels of management, i.e. that the Top Management expend especial efforts on supporting creativity, innovation and change. That they seek ways and means of possible improvement because in change lies competitive advantage. Professional skills and abilities are not enough, what is essential above all is creative skills and abilities (e.g. the breaking-down of habits, the abandoning of obsolete systems), and task-based and oriented motivation.

It is essential to support creativity through the creation of optimal internal conditions within an enterprise, i.e.:

?? Unambiguous support on the side of the management, the creation of a supportive internal climate.
?? A greater degree of autonomy, delegating powers to others.
?? The unambiguous differentiation of remuneration according to performance.
?? Greater leeway for risk-taking (even the Top Management must accept a greater degree of risk)
?? The training of creativity.
?? A tolerance for variance from the norm, the respecting of individual alternative solutions.

Enterprises which train their employees towards an attitude of creative thinking can expect the following benefits:

?? A staff, which is supported in their creativity will better understand the ideas and opinions of their co-workers and will communicate better.
?? Employees will be capable of an easier cooperation with other members of their working teams.
?? The level of competition will increase within the framework of a team and between different teams.
?? Apart from developing their high-tech strategic skills and abilities in their thinking processes, a global perception and thought pattern will also evolve.
?? The final effect will be expressed in innovative changes, which will lead to the enterprise being better placed to assert itself on the markets of the EU.

Methodology

Our researches were concentrated on comparing the differentiated conditions governing preparations, in that we tried to discover how these are expressed in the development of the individual factors of creativity and also on the training of creative thinking that prepare managers for a more effective way of working and at the same time, lead to increasing self-satisfaction and self-realisation. Apart from this, we also evaluated other factors designated as decisive for certainty. The comparison was of activation methods with traditional means of preparation (training) – simulation methods and role-playing, case-studies and traditional forms of preparation. It is true that the training methods were, in certain cases, quite heterogeneous and that in certain situations it would be possible to designate to some degree some of these methods as simulation methods, since case-studies were used. But, the case-studies used were used because the criteria by which the methods used were classified, allowed a greater degree of freedom in ranking them among the case-study methodology. A further weak point in this project is given by the Export Sales Departments which took part in this experiment only underwent 2 hours per week of differentiated forms of training over the course of a year, which represents a mere 10 % of the overall training time that the course participants went through. In total, 159 test subjects took part in this research. Of these, 110 were men and 49 were women. In the course of one year, three measurements were carried out.

Interpretation

In comparing the development of the individual factors influencing creativity, it was shown that the most effective in influencing the development of creativity proved to be the simulation and role-playing methodology (i.e. the Kruskal-Wallis Test). And this was true for three factors: fluency, originality and sensitivity. Where the values were compared with the Friedman Test, then this was true for four factors: fluency, originality, sensitivity, and elaboration. Demonstrable changes in fluency apply only to certain elements – i.e. verbal fluency and expressive fluency. The outcomes in the sub-test of associational fluency and idea/conceptualisation fluency did not demonstrate any significant changes.

As regards originality, it was demonstrated that changes were achieved in the outcomes of the sub-test: Outcomes of Fictive Events, but it was not demonstrated in the sub-test: Entitling Tales/Stories. For sensitivity, demonstrable results were noted in the sub-test: Seeing (Perceiving) Problems; while it was not demonstrated in the sub-test: Improving Instruments. These all have to do with changes which are compared to the original/inception state as at the time of initial measurement (of these factors). It was also demonstrated that change occurred in Decisive Certainty – which is of course the expression of the degree of a belief in oneself (self-confidence), a belief in one's abilities and a certainty about one's competence.

In the selection of those prepared with the assistance of case-studies methodology, an effect was shown for two factors: fluency and sensitivity. These demonstrable changes also affected only some of the sub-tests used in this study. For fluency, these were the sub-tests which measure expressive fluency and idea/conceptualisation fluency. With sensitivity, this was demonstrated in the Seeing (Perceiving) Problems sub-test.

A significant improvement in performance was noted in one sub-test as well in the selection of traditional training methodologies. This was in the sub-test: Expressive Fluency. Should we consider the evaluation outcomes of the investigations using the Friedman Test, then there was also a significant growth in the sensitivity sub-test: Seeing (Perceiving) Problems.

In those sub-tests, where a demonstrable result in all three groups can be noted, it is possible to say that the effect on a significant growth in performances is not influenced by the tuition methodology used. And if it is, then this is an element which uncontrollably occurs in all the methodologies used. If we compare the effect of the influence of the individual methodologies between themselves in each of the 3 measurements, then the growth rate in the 2nd and 3rd is significantly different, when comparing all three selections, then this differentiation is somewhat less evident.

In the course of the 2nd measurement, i.e. in the middle of the whole experiment, a demonstrable difference appeared in the Idea/Conceptualisation sub-test – in the sense that a growth in performance in those selected for preparation with the assistance of case studies significantly differed from the 1st. Group (i.e. the group training using the Simulation and Role-playing methodology) and from the 3rd Group (i.e. the group prepared using traditional training methods). This means that the Case-study Method develops resourcefulness, i.e. the ability of knowing how to react to new situations, much more than does the Simulation and Role-playing methodology, or traditional forms of training.

As regards the longer-lasting effects of these differentiated training methods further differences in their effects were also noted in the outcomes. At the end of the experiment, i.e. in the course of the third measurement phase, a demonstrable differentiation was shown in the Verbal Fluency sub-test, the Originality sub-test (i.e. Consequences of Fictive Events), and in the Decisive Certainty sub-test.

For the Verbal fluency sub-test, there was a significantly better performance in the 1st and 2nd Selections. This means that both activation methods function (affect) verbal production much more significantly than do traditional training methods. It was not anticipated that there would be such an occurrence of phrases and learnt formulations, which tend to predominate in traditional training methodologies. This outcome did not confirm our expectations in full measure. The presumptive outcome, that all selections would have approximately the same growth (improvement) in performance, is in contradiction to the hypothesis, which flowed from a comparable communication burden, with an approximately similar extent of the language used.

In the Originality sub-test (i.e. Consequences of Fictive Events), a significant improvement in performance was noted for those selected for preparation by means of the Case-study methodology. Even in this case, the hypothesis was not confirmed in full. We had anticipated that the group prepared using the Simulation and Role-playing methodology would also have a similar growth in their performance levels, since the Simulation and Role-playing method frees-up spontaneity, playfulness, frees a person from their fears of the reactions expressed by others and of a lack of success. The outcomes of the research conducted by Parlett and Hamilton (c.f. Parlett, M., Hamilton, D., pp.120, 1987) confirms that the Simulation and Role-playing method leads to the strengthening of alternative thought-processes, strengthens a more initiative-led approach to pragmatic thinking and in seeking possible ways of arriving at solutions to problems.

For the Decisive Certainty sub-test, a significant improvement occurred in the third measurement phase (i.e. at the end of the whole period) for the groups selected to undergo the Simulation and Role-playing method and the case-study method. It can be said that hypothesis ? .12 was confirmed in full and that the activation methods have a much greater influence on the degree of self-confidence, relaxation, and a willingness to take more risks, than traditional forms of tuition. This is confirmed by the outcomes of the investigations conducted by Parlett and Hamilton (c.f. Parlett, M., Hamilton, D., pp. 120, 1987) in the form of increased decisiveness, motivational interest, and increased self-confidence.

If we were to compare the development of the potentials of the individual factors of creativity who are highly creative and those with lower expectations, it would be possible to see differences in a whole range of sub-tests.

The Fluency factor shows overall a high degree of similarity in the development trends of both selections. Both Expressive and Idea/Conceptualisation Fluency grew in a similar manner for both selection factors. The changes that occurred in the course of a year are, in both cases, significant. The differences are only in the time frame of this growth and the slow down in performance. More creative individuals have a markedly greater growth in the Expressive Fluency sub-test than before, in the first half of the year. The less creative individuals have an accelerated course of growth in the second half of the year. This pattern is similar for the Idea/Conceptualisation Fluency factor.

Associational fluency was significantly improved in the selected category of highly creative individuals. From individuals with a lower creativity potential, growth in performance was remarked in the second half of the year, but the changes cannot be interpreted as having been demonstrated.

Semantic Flexibility was demonstrably improved only for the selected category of highly creative individuals.

This is similar for the results of the Originality (Consequences), Elaboration, and Decisive Certainty sub-tests. This means that the activation methods work with greater effect and more influence upon more creative individuals, especially in the initial phase. Change also occurs with those in the less creative test group; it is only that the whole course of events has a more gradual character, which is expressed in a greater growth rate (in an evincible measure) only in the second half of the annual period. This is a definable indication, which differentiates the two groups from each other, i.e. the Highly Creative Individuals and the Less Creative Individuals. The less creative individuals probably require a lowering (freeing-up) of their barriers and their creative development needs more positive stimuli, as well as more time for their activation and self-development.

In the following two sub-tests, these demonstrable changes are comparable in both selection groups, i.e. the Sensitivity (Seeing/Perceiving Problems) and the Anagram sub-tests. This means that, for these two factors, the positive influence of the activation method expressed itself in a comparable measure in both groups. Their effectiveness however has no differentiable effect according to the degree of latent creativity.

Of the overall sum of 13 hypotheses, only two were fulfilled in full measure. A further five hypotheses were partially fulfilled, these were Hypotheses ? s. 1, 8, 11,12, and 13. All of the other hypotheses were therefore repudiated.

Conclusions

The sense of this experiment was to respond to the question, whether it is possible to increase the effectiveness of the influencing and development of creativity in the educational process, when preparing (breeding) managers and directorial employees of manufacturing and commercial enterprises under the conditions prevailing in the Czech Republic. The aim was to determine whether the development of all the selected factors was equally effective. Which preparation methods had a greater positive influence on Fluency, Flexibility, and which on Originality or Transformation, or on Sensitivity; i.e. what aspects of a creative personality is it possible to develop through the application of training method.

In view of the differences in the individual methods, it is possible to state in conclusion that none of the tuition forms has a universal application, and that it is not possible to say which of these is the best. The most effective approach to this form of tuition is an optimal compromise, the rotation of the application of all of these approaches, and the smooth transition from one form of tuition to another, since each of them has its own specific effects, but also a complex of effects, since they function in a generative manner on creativity as a whole. It makes sense that one set out to create habits in the ways of thinking which develop differentiation and independence.

The specific benefits of the Role-playing Method are expressed in improvements in Verbal Fluency, in Originality, in the Resolution of Anagram-type Problems, and in Decisive Certainty. The Case-study Methodology's influence is positively felt in the development of the Sensitivity Factor in the sense of Understanding

Problems and Circumventing Complications. All of the above methods have a positive influence on the development of Expressive Fluency. The specific effects of the Case-study Methodology are expressed in the Idea/Conceptualisation Fluency Factor.

For the Traditional Training Methodology, no specifically positive effects were demonstrated, but they play a positive role in the complex positive effect on the development of Expressive Fluency.

Rotation of the methodologies used also makes sense since it creates an atmosphere of change and novelty, which in and of itself has a motivational effect; it is creative and helps to develop creativity.

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Performance Appraisal as a Form of Formal Communication: A Case of Slovakia

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Abstract

The article seeks to find in what forms performance appraisal is presented in Slovak organizations and to depict how its presented forms are linked to other human resource management activities. In addition, we examine whether the managers comprehend and utilize performance assessment as a tool to motivate their subordinates and whether it influences communication within an organization. The findings of the article are based on research examining a sample of 52 companies operating within the Slovak Republic. A total number of 718 questionnaires was sent with the final count of returned questionnaires amounting to 512 from 35 organizations representing 432 respondents from Slovak companies and 79 from those with capital investments from abroad. Overall, the enterprises involved in the research cumulatively employ 11,765 people.

Introduction

Communication among members of an organization, as well as between them and the external environment, is one of the most critical organizational processes, influencing overall performance and effectiveness. Internally, communication is presented in organizations in two channels, formal and informal. Formal communication is most frequently used in the form of policies and procedures; the informal helps to create social communication networks[1]. From the managerial point of view formal means of communication, presented by different managerial activities, play an important role in setting the standards for various procedures and activities in a given organization. Moreover, their content and form contribute to enhancing the justice and fairness of the system of management, and thus improve employee satisfaction and motivation.

Performance appraisal, as a formal mean of communication, is an indivisible part of an efficient human resource management system in any given organization. On the individual level it represents a crucial tool to foster participatory objective planning, to improve employee motivation and to encourage high quality work performance. On an organizational level, it links other human resource management (HR) activities, such as compensation, training and development, as well as career management, making it a backbone for the management practices within an organization. As a result of these many faceted roles, performance appraisal has become a part of a more complex managerial tool, performance management. The concept of performance management considers three areas: defining performance, measuring performance and feeding back performance information[2]. From the perspective of managerial communication, providing feedback is the most critical aspect of performance management, requiring high quality formal communication skills. The performance feedback process, however, is complex and provokes anxiety for both the manager and the employee. On the other hand, if individuals are not made aware of how their performance is not meeting expectations, their performance will almost certainly not improve. Thus, an effective manager must posses the ability to provide specific performance feedback to employees in a way that elicits positive behavioral responses. This criterion is most often met by providing objective and fair feedback. The process of feeding back information to employees also often represents a procedure of setting future goals, through which managers can improve employee motivation. Noe, Hollenbeck, Gerhart and Wright identify three approaches to the feedback session: a) *tell and sell* (managers tell employees how they have rated them and then justify these ratings), b) *tell and listen* (managers tell employees how they rated them and then let the employees explain their part of the story) and c) *problem solving* (managers and employees work together to solve work performance problems in an atmosphere of respect and encouragement)[3]. In spite of the research demonstrating the superiority of the problem solving-solving approach, most managers still rely on the tell-and-sell approach[4]. When employees participate in the feedback session, they are consistently satisfied with the process[5]. Research has demonstrated, that employee active participation in the goal setting process is one of the most effective motivators[6]. Further on, it has shown that it results in increased satisfaction, motivation to improve and performance enhancement[7]. Overall, the purposes of an effective performance management system are to link employee activities with the strategic goals of an organization, to furnish valid a useful information for making decisions about employees and most importantly to provide employees with developmental feedback. To fulfill these purposes, communication is a critical aspect.

Aim of the Research

In 1989, there was a significant change of the political system in Slovakia that was followed by a transition from a centrally planned to market economy. This transition caused a shift in the nature of business environment that has moved from being relatively stable and predictable towards a more competitive and frequently changing system. The employment mode has shifted from egalitarian towards a tournament – there has been growth in usage of pay-for-performance compensation models where seniority matters less than ability to perform along with decline of average age of managers, and more mobility between jobs[8]. Such a shift has called for more flexibility of managers and workers, for market orientation in designing HR activities, and for redefining the role of human resource management as a strategic partner within the managerial activities in the companies. Within the redefined HR system, quality of work and performance are the key success indicators. In the past decade, it has been mainly foreign multinational companies entering the Slovak market, which have been introducing different managerial practices and influencing the changes in the business environment. Slovak companies, in order to stay competitive, have had to introduce different style of management and change the attitudes and skills of their managers. The new required managerial skills include participative decision-making, active listening, providing feedback, counseling, coaching, and conflict resolving[9]. All of these skills are crucial in the process of assessing performance, placing a heavy emphasis on communication abilities of managers. Thus, as the concept of performance appraisal is a fairly new phenomenon in the Slovak business environment, we seek to find in what forms it is presented in Slovak organizations and to depict how its presented forms are linked to other human resource management activities. In addition, we examine whether the managers comprehend and utilize performance assessment as a tool to motivate their subordinates and whether it influences communication in an organization. Moreover, we looked at the ways managers communicate feedback to their subordinates, focusing on its content.

Survey Data

The findings of the article are based on research that examines a sample of 52 companies that operate within the territory of the Slovak Republic. There were a total number of 718 questionnaires sent with final count of returned filled out questionnaires amounting to 512 from 35 organizations. The enterprises actively involved in the research cumulatively employ 11,765 people. There were 432 respondents from Slovak companies and 79 from those with capital investments from abroad (in one case the respondent did not state, whether he/she worked for Slovak or foreign company). We have considered this sample sufficient to generalize the main trends in a particular HR practice within the business environment of Slovakia. To achieve an objective view, we have addressed companies from all regions of Slovakia, companies of different sizes, and both Slovak and foreign in terms of capital investment [Note: further in this text companies with foreign capital investment are often referred to as "foreign" for simplicity of terminology]. We have addressed managers at all levels of management. We have not addressed employees who are not in managerial positions and do not supervise any subordinates. Moreover, as the questionnaire was in Slovak language, foreigners working in the Slovak Republic were not included in the sample.

Research Methodology

We created a questionnaire that is comprised of three parts. The first section regards the demographics of the respondents, asking their gender, position in the company (top, middle, low level management), type of ownership of the company (Slovak or with foreign capital investments); the number of employees in the company as well as the number of direct subordinates. We have also asked the respondents to identify their age by choosing one of the following categories: less than 30 years of age, 31-45, and 45 and more. Additionally, we asked the respondents to indicate their tenure with the organization. We have included four categories: working with the company for up to one year, two to five years, six to twelve years, or more than thirteen years. The second part of the questionnaire consists of 30 statements evaluated on a 1-5 Lickert scale, where '1' indicates the least acceptance of the statement and '5' indicates that the respondent fully agrees with the statement. There are various statements from different areas that evaluate the attitudes of managers towards their work, their managerial style, and communication style. For the purpose of this paper we have analyzed only questions related to performance appraisal, its forms, links with other human resource activities and the awareness of the importance of the content on the manager's part.The third part of the questionnaire consists of questions where the respondents were asked to evaluate statements qualitatively, indicating all the responses that are relevant or those that are the closest to what they think about the statement. There was also space available for personal responses/comments. For the purpose of this paper, only those questions were analyzed that were relevant to the topic. In these questions, we have not received any individual open-ended responses, so there was no need for additional grouping and coding.

Research Results

Demographics of the Respondent Group

The demographic characteristics of the respondent group were as follows. There were 115 (22.55%) top managers, 205 (40.2%) middle managers, and 190 (37.25%) line managers. The group consisted of 390 (76.32%) male respondents and 121 (23.86%) female. Out of the sample, 64 (12.52%) were younger than 30, 190 (37.18%) were from the group 31 – 45 years of age, and 257 (50.3%) people were older than 45. There were 432 respondents from Slovak companies and 79 from those with capital investments from abroad. There were 511 respondents who identified their tenure, out of which 33 (6.46%) have worked less than one year for a company, 101 (19.77%) who have worked 2-5 years with the company, 123 (24.07%) who have worked 6-12 years with the company, and 254 (49.71%) who have worked longer than 13 years with the company.

Performance Appraisal Techniques in Slovak Organizations

The *first goal* of our research was to *identify the performance assessment techniques used* in Slovak organizations. The selection of the technique is an important factor influencing the success of the overall process of performance appraisal. The most often used techniques in our sample as a whole were appraising employees without their knowledge of being evaluated and an appraising interview (Table 1). The interaction between a manager and subordinate in a form of interview provides a platform to clarify the performance quality requirements and at the same time aids in identification of training and development needs. Additionally, it presents an opportunity for further goal setting and establishment of a working relationship between the manager and the subordinate. However, it demands high quality communication skills from the manager, especially in terms of objectivity and fairness. Also, an interview provides a better environment for linking assessment of performance with other human resource management activities, thus creating performance management. Last but not least, following "interactive" assessment interview, future goals can be mutually agreed upon. There proved to be a major difference in using assessment techniques requiring communication skills, when looking at the sample from the perspective of the ownership of the company. Here we see a dramatic shift in the preference of the selected technique. In foreign companies, the interviews outnumber all other techniques – they are used in 69.62% cases (Table 2). This indicates a certain level of reluctance from the Slovak managers to communicate on a "person-to-person" basis the results of the performance assessment, which also has significant consequences in terms of setting future goals with the employees. More in-depth analysis of the sample shows, that Slovak managers, when assigning tasks to the employees, prefer to do so in a written form, even if a dialogue precedes it. This does not provide space for managers and their subordinates to clarify expectations and and also to discuss possible steps to enhance or correct performance[10].

TABLE 1. PERFORMANCE APPRAISAL TECHNIQUES USED IN SLOVAK COMPANIES

WHAT FORM OF PERFROMNACE APPRAISAL IS USED IN YOUR COMPANY?					
	A	*B*	*C*	*D*	*E*
Employees write their own self-evaluations **A**	1.75 %				
Evaluation interview **B**	0.97 %	**23.24%**			
Superior evaluates subordinates without their knowledge **C**	0 %	0.42%	**27.14%**		
Superior ranks the employees according to their performance **D**	0 %	1.56%	1.36%	18.16%	
Employee is evaluated by multiple parties **E**	0.19%	1.56%	0.42%	0.97%	14.06%

Respondents were allowed to mark multiple answers if applicable; the chart is of matrix type, i.e. cell AA represent a single answer, whereas columns represent all possible combinations of answers

TABLE 2. COMPARISON OF THE PERFORMANCE APPRAISAL TECHNIQUES USED IN FOREIGN AND SLOVAK COMPANIES

	SLOVAK	FOREIGN
Employees write their own self-evaluations	2.31%	7.59%
Evaluation interview	**20.37%**	**69.62%**
Superior evaluates subordinates without their knowledge	32.87%	10.13%
Superior ranks subordinates in order of their performance	24.31%	11.39%
Employee is evaluated by several parties	18.06%	15.19%

*Respondents were allowed to mark more than one answer

Content of the Feedback – Managerial Role in Performance Appraisal

The *second goal* of our research was to *identify, whether or not managers realize the importance of the content of the feedback process* in order to provide objective information and thus fulfill the motivational aspect of performance management. Performance appraisal provides an environment for both manager and subordinate to learn, explain and clarify each other's expectations and attitudes. What is important for a manager to learn during performance appraisal reflects his or her style of management, their inclination towards achieving goals and/or understanding their subordinates. In our questionnaire we asked managers to indicate their preferred approach to the quality of the message and interest in the relationships among the employees and in the personal life of the employees. Here, multiple answers were also possible, and we have seen them more among managers from foreign companies than from Slovak ones. Only approximately 10% of managers from both groups think that they should evaluate only achieved goals. Although both groups of managers agree that the evaluation should be factual and not biased (70.37% from Slovak companies; 63.29% from foreign), managers in foreign companies put more stress on the fact that they should provide both positive and negative feedback (77.22% compared to 32.64% of Slovak managers). They also show more interest in personal problems of the employees (15.19% compared to 9.72%) and in the relations among the employees (30.38% compared to 15.28%). The form of performance assessment, again, enables this: the interview, as a dialogue, can give rise to issues of interpersonal relations of the subordinates and thus a more complex understanding of their work-related attitudes. Moreover, the results show, that there is overall awareness on the manager's part that objectivity and fairness are important features of the performance assessment process, yet a certain gap exists in practices between Slovak companies and those of foreign capital ownership.

TABLE 3. MANAGERIAL ROLE IN PERFORMANCE APPRAISAL

IN YOUR OPINION, DURING PERFORMANCE APPRAISAL EVALUATION, THE MANAGER SHOULD			
	Total	**Slovak**	**Foreign**
Evaluate goals	9.78 %	9.72 %	10.12 %
Show interest in personal problems of subordinates	10.56 %	9.72 %	15.19 %
Evaluate matter factually	69.27 %	70.37 %	63.29 %
Show interest in the relationships among subordinates	17.61 %	15.28%	30.38 %
Provide both positive and negative feedback	39.53 %	77.22 %	32.64 %

*Respondents were allowed to mark more than one answer

Use of Performance Appraisal Results Within the Human Resource Management System

The *next goal* of our research *focused on depicting how performance management systems in organizations in Slovakia link with other human resource management activities*. The link of performance appraisal with other human resource management activities is important from multiple perspectives: a) it fosters person-to-person communication within organization on a formal level and establishes relationships b) serves an employee developmental purpose and c) creates a performance management system and enables the organization to align individuals with its strategic goals.Almost 40 percent of respondents stated, that the information obtained from performance appraisal is solely used in compensation; 12.69 percent of respondents identified that the results are used in the goal setting process. Less than 5 percent of the organizations use the information in specifying the needs of further training or career development (Table 4).We consider this insufficient utilization of the information about the employee performance, which the Slovak organizations possess. If the performance assessment is to serve its multiple purposes within the HR system, it needs to be linked to other activities, specifically assessment of the trainings needs and setting the future goals for the employees. Moreover, some of the used techniques (mainly 360 feedback and self-evaluation) are more frequently used in career development and assessment of training needs and are not suitable for decisions about compensation because they tend to become less reliable[11]. Thus, it is necessary for organizations to re-evaluate the suitability of the selected performance appraisal technique. Additionally, the selected technique influences the feedback communication style.Following these findings we decided to look at the differences between the practices of Slovak companies and those of foreign capital ownership. The main difference in using the information obtained in performance appraisal was in using the information for identifying further training needs, career development and goal setting (Table 5). Foreign companies use performance appraisal as a strategic tool; not only to evaluate past performance of employees, but also as a developmental practice for future growth of their employees. This finding is important particularly from the perspective of the communicational role of performance appraisal. If consistency is to be reached within the HR policies of the organization, communication of the results of performance assessment along with their utilization is a mean to obtain it. It is also interesting to see that almost all foreign companies apply the information from performance appraisal in some way, while Slovak companies slightly lag behind with 8.56% of them not utilizing information from performance appraisal at all. This finding is in correspondence with the above-mentioned difference between Slovak and foreign companies in using interview as the main feedback practice. The analysis of training needs, career development and setting further goals requires intensive communication from both parts, the manager as well as the subordinate, and should be mutual to achieve consensus and further employee development.

TABLE 4. USE OF PERFORMANCE APPRAISAL RESULTS IN SLOVAK ORGANIZATIONS

INFORMATION FROM PERFROMANCE APPRAISAL IS USED IN						
		A				
Compensation	**A**	**38.28%**	*B*			
Analysis of training needs	**B**	4.88 %	3.51%	*C*		
Career development and career growth	**C**	2.92%	0.39%	1.36%	*D*	
Setting of further goals	**D**	6.64%	0.78%	0%	12.69%	*E*
Are not used for any of the above	**E**	0 %	0%	0%	0%	7.42%

*Respondents were allowed to mark multiple answers if applicable; the chart is of matrix type, i.e. cell AA represent a single answer, whereas columns represent all possible combinations of answers

TABLE 5. COMPARISON OF THE USE OF PERFORMANCE APPRAISAL INFORMATION IN FOREIGN AND SLOVAK COMPANIES

	SLOVAK	FOREIGN
Compensation	65.05%	73.42%
Analysis of training needs	16.20%	**51.90%**
Career development and career growth	9.26%	**46.84%**
Setting of further goals	27.08%	**44.30%**
Are not used for any of the above	8.56%	1.27%

*Respondents were allowed to mark more than one answer

Motivational Aspects of Performance Management

The final goal of our research was aimed at finding out whether managers see performance appraisal as a tool to enhance the motivation of their subordinates. If performance appraisal is to have a motivational character, it is important that it is communicated in a factual manner, objectively and on time (it has more motivational effect, if it is communicated right after a certain performance takes place). Moreover, it is very important from the motivational perspective, that the employee does not feel his/her performance is appraised using double standards; in other words, employees have the tendency to compare each other and it is important they feel the appraisal is just. From the communication aspect, the style of communication plays important role; more accepted the message of the rater, more motivational it is for the 'ratee'; increasing trust, satisfaction, organizational commitment and citizenship on the subordinate part. Vast majority of the respondents of the sample feel that performance appraisal has motivational impact on the employees. However, here we came to interesting conclusion. Even though almost 83% of the respondents think that performance appraisal is motivational, only 66 % percent evaluate performance on regular bases. The difference between the practices of Slovak and foreign companies were apparent here, where there was much stronger relation between the practices and realization of motivational aspect of performance appraisal in foreign companies than in Slovak ones.

Discussion and Limitations

This study has proved that performance appraisal is used on Slovak companies as a mean of formal communication, because it is used as a basis for other HR activities and managerial decision-making. It also shows that performance appraisal is a source of feedback for the employees and helps foster consistency of other human resource management activities. It has showed, that performance appraisal is present in Slovak organizations in various forms, however it also depicts that there is adifference in usage of performance assessment between Slovak companies and companies with foreign capital investment, with the later being more advanced, especially in relation to person-to-person communication. Slovak companies show tendency to be reluctant to a "personal" approach of communicating feedback to their employees. If performance appraisal is to be an effective tool of human resource management, increasing employee motivation and satisfaction, it is to be based on two-way communication between he manager and the subordinate. Additionally, the result of the research showed, that if feedback is communicated personally, there is more tendency to link the performance appraisal to other human resource management activities (as in case of foreign companies present in the Slovak market), creating environment for management by objectives (MBO) approach along with setting the platform for employee development; as in the case of foreign companies. Moreover, it aligns the individual employee development with strategic goals of an organization, contributing to creation of competitive advantage. Performance management, especially its feedback providing part, places high demands on managers in terms of communication skills and the organizations (specifically those of Slovak capital ownership) have to pay attention to the management "communicational" development, as it promotes person-to-person communication channels, establishes relationships and serves employee developmental purpose. Thus, the Slovak companies should focus on management development, promote "personal" ways to provide feedback and to use performance appraisal as a "future oriented - developmental" tool rather than focusing solely on past performance.

Conclusions

Communication among members of an organization, as well as between them and the external environment, is one of the most critical organizational processes, influencing overall performance and effectiveness. Performance management, as a mean of communication in organization, informs the employees of the quality of their work and often of the performance of a department or a team or even the results of the whole organization. It is used to ensure that employee activities and outcomes are congruent with the organization's objectives resulting in the company's successful implementation of strategy. With performance as success indicator, the need to assess performance and benefit from the gained information has become a vital part of managerial job and a common practice in the Slovak business environment. Managers in Slovakia understand it as a tool to motivate their subordinates and incorporate it into activities they regularly perform. It is necessary, however, to ensure, that the techniques used in the process of performance appraisal are chosen in a way, that validity and reliability of the selected performance assessment practice are of the highest possible scores. In Slovakia, performance is assessed on regular basis and the gained information is then used for decisions about compensation, training and development, and for setting further goals. However, there is a gap between managerial practices of companies that have foreign capital investment and those that are Slovak, especially in the person-to-person communication used by managers.

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Trends of Flexible Work Arrangements and their Applications in the Slovak Republic

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Abstract

The issue of labour flexibility is currently prominent in industrial relations across the European Union and beyond. It is in this context that this research seeks to examine: the background to the growing importance of this theme in Europe; the view and strategies of the parties (employers, trade unions and governments); and occurrence of different flexible work arrangements in use in the Slovak Republic.

Given the scope of the changes, which have occurred, in the area of labour market over recent years, the research finds that it is unfortunate that only incomplete and disparate statistics and analyses are currently available. An international comparison in this area can thus be only of a qualitative nature.

I Flexible Work Arrangements Overview

1 Introduction

Over the quarter of a century of rapid growth with almost full employment, which followed the Second World War, the regulation of working time in Western Europe followed a number of rules, which steadily became general throughout the continent. These basic rules were as follows:

- for full-time workers, the law set maximum and normal durations for hours worked and companies adopted stable collective work timetables. The margins for flexibility were provided by the use of overtime working and temporary unemployment (lay-offs and short-time working);
- the only role for collective agreements was to improve on statutory provisions, mainly by reducing the length of the working week and increasing the length of paid holidays;
- the reduction of working time was seen as a part of social progress. It was one way, along with pay increases, of sharing productivity gains; and
- atypical working hours were used only to solve specific problems. First, night and weekend work fulfilled certain technical needs related to production, or the needs to keep some public services open at all times. Second, part-time work, which accounted for an increasingly large proportion of the workforce, especially in northern Europe, fitted a widespread social model of women's economic activity, and it was the same logic which brought about, at the end of this period, some experiments with flexible working hours ("flexitime") for office workers.

For the past 25 years, this framework has been in the process of profound transformation due to the conjunction of developments of varying nature, such as: new forms of organisation of production and marketing; the intensification of international competition; increasing unemployment; and new needs and preferences among male and female workers regarding the organisation of their working time. The disparate nature of these changes explains why the move toward introducing flexibility into working time has reflected different, and often contradictory, interests and objectives, depending on the economic and social actors concerned.

The theorists have tried not only to identify the most appropriate forms of work arrangements, but also to class the layers of employees concerned.

Thus, any survey of non-standard working from the employer's perspective must start with a description of the now classical work of John Atkinson (1984) and, in particular, his proposed model of the "flexible firm". Its main feature is the suggestion that a flexible firm (by which Atkinson means one that is competitive in the modern business environment) is composed of three basic groups of employees: core workers, peripheral workers and a third group who are employed only on some kind of subcontracted basis. The basic model is illustrated in Figure 1.

Central to the model are two distinct types of flexibility: functional and numerical. The former is applied specifically to the core workers – that is, people who are employed on standard, permanent, full-time contracts and who undertake the tasks that are central to the success of the organisation. They are functionally flexible, in that they do not work to rigid job descriptions but carry out a broad range of duties. Moreover, they do not restrict their activities to work of a particular level. Instead, they carry out complex tasks associated with managerial or professional jobs as well as more mundane activities, depending on the day-to-day needs of the organisation.

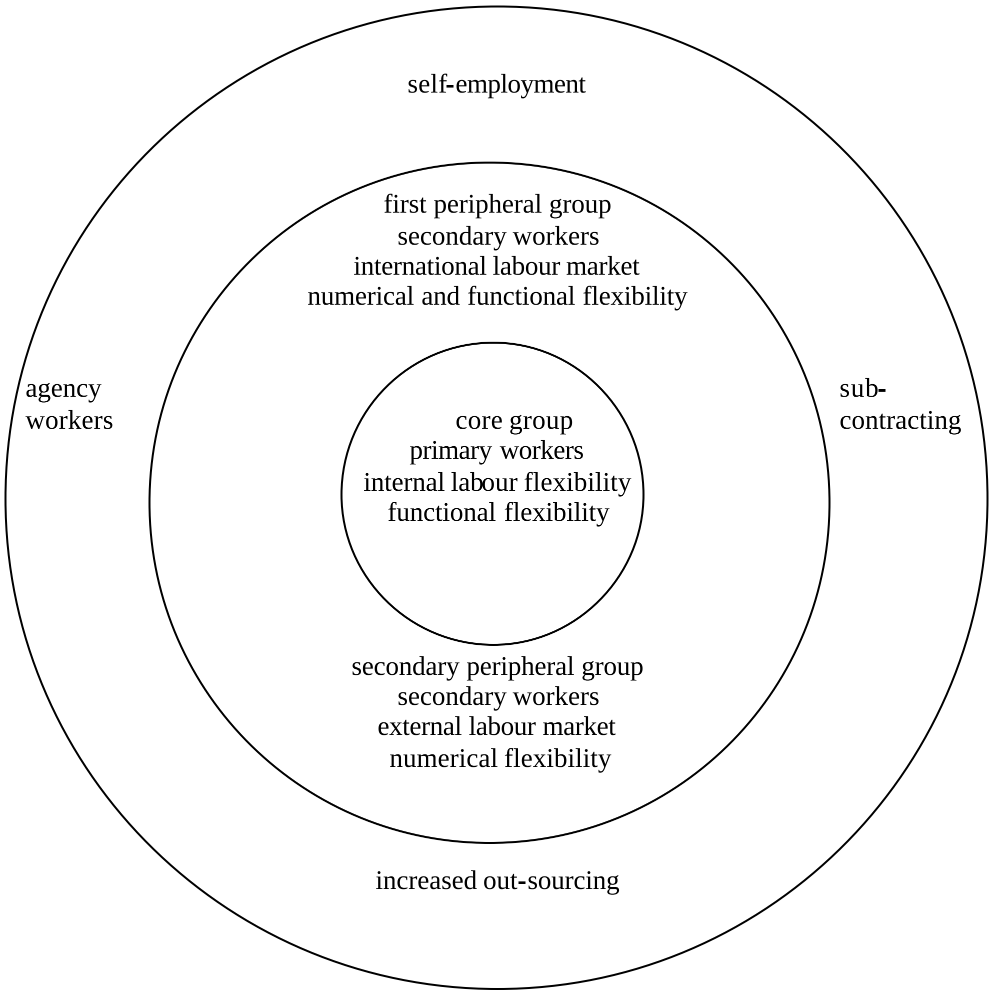

FIG. 1: THE FLEXIBLE FIRM

Source: Atkinson (1984)

The peripheral group can also be functionally flexible, but in the model is more strongly associated with the term "numerical flexibility and temporal flexibility". Atkinson divided peripheral workers into primary and secondary categories, the first forming part of the firm's internal labour market. These people are mainly full-time and have a certain degree of permanence, but tend to have lower skills than colleagues who enjoy the status of core employees. As individuals they are less central to the organisation's success because their skills are more widely available in the labour market. They therefore enjoy lower job security than the core workers and will be among the first to have their hours cut or to be laid off when business downturns are experienced. The secondary peripheral group members are in an even more precarious position, because they are brought in mainly to help cover peaks in business or short-term needs resulting from the absence of other staff. They are employed either on a part-time or temporary basis.

The final group, located beyond the periphery, consists of people who are not employees of the firm but who are hired on a subcontractual basis to undertake a particular task or set of tasks. In the vast majority of cases this will be temporary, and hence insecure, although it is possible for a series of fixed-term contracts to follow one after another. Some may be professionally qualified people working on a self-employed basis; others may work for an agency or some other service provider. In both cases they are perceived by the other groups as being external to the organisation and thus readily replaceable by a competitor should their work prove to be unsatisfactory or more cheaply provided elsewhere.

Over recent years others have proposed similar models (eg Loveridge and Mok 1979, Handy 1989). In *The Empty Raincoat* Charles Handy (1994) suggests that employers will increasingly wish to buy a specific *service* from a worker rather than that person's *time*. The result will be a situation in which, for most people, there will be little opportunity to enjoy the security of a long-term, full-time job. Instead, Handy believes, people will have to develop portfolio careers in which they earn money by "looking for customers, not bosses". Employers will be both far less willing and able to employ people (especially professionals or "knowledge workers") to come to their premises for a fixed number of hours each week. Rather, they will say, "Do this by this date; how you do it is up to you, but get it done on time and up to standard." The term "job" will thus revert to its original meaning of a specific task or project rather than an occupation or profession, while individual ambitions will focus more on the achievement of employability than the status of being an employee. The same kind of analysis also underlies other influential publications concerned with the future of work, some writers going further than Handy in respect of the speed with which and the extent to which they believe these developments will occur (eg Bridges 1995, Rifkin 1995, Davison and Rees Mogg 1997).

A number of others have come out in opposition to some of these ideas, and particularly to Atkinson's model, such as Anna Pollert who has argued in a series of books and articles that there is nothing particularly new about flexibility as it is described by Atkinson. Firms have always had to slim down their workforces when faced with difficult business circumstances, and they have always shed subcontractors and peripheral workers first. What is new, according to Pollert (1987, 1988), is the promotion of flexibility in the form of a model intended to guide management actions. In other words, it is the idea that organisations should deliberately develop core and peripheral structures as part of a considered strategy that represents a departure from past practice. However, she goes on to argue that there is little evidence that managers are in fact adopting such strategies. Her point of view appears to be backed up by the survey evidence, which has persistently shown that while the extent of self-employment, temporary and part-time work has increased in recent years, this results from managers' reacting on an *ad hoc* basis to specific needs (Hakim 1990, McGregor and Sproull 1992), reflecting a continued demand for part-timers in retailing, catering and publishing. Since 1994 has in fact seen the creation of substantially more permanent jobs than temporary ones (Donkin 1997).

Moreover, we can see that trends in different kinds of non-standard working affect different industries unevenly. For example, there is relatively little part-time working in manufacturing, but there is a good deal of subcontracting. By contrast, the use of fixed-term contracts has grown most in the public services, where funding to undertake specific projects is limited in terms of time. Such contracts are also used extensively by employers whose workload increases and decreases on a seasonal basis (eg in tourism and agriculture), and have necessarily become highly significant in sectors where most employees are female, as a result of the greater take-up of the right to maternity leave in recent years.

Thus, the interest in flexible arrangements of work go far back to the history. However, for a long time its various forms were used by individual employers or were typical just for particular sectors. Only at the end of the last century the more systematic approach shaped into consistent research into the field on the one hand and the first legislative steps on the other. Back in 1998, the European Commission's Green Paper on Partnership for a new organisation of work devoted considerable space to the question of a new approach to working time, examining both reorganisation and reduction. The EU Guidelines for Member States' employment policies 1998 underlined the importance of work flexibility, and the social partners' role in achieving it, in employment creation/preservation. The guidelines invited the social partners "to negotiate, at the appropriate levels, in particular at sectoral and enterprise levels, agreements to modernise the organisation of work, including flexible working arrangements, with the aim of making undertakings productive and competitive and achieving the required balance between flexibility and security". However, it was still too early, according to the Commission's May 1998 review of the National Action Plans developed by EU Member States in response to the guidelines, for the social partners' response to be fully developed.

2 Categories of Flexible Organisation of Work

Working time flexibility may be defined as permanently variable and adjustable working time in terms of structure and length. Working time flexibility is closely associated with the notions of the flexible firm on the employer's side and time sovereignty on the employee's side.

Working time in an employment relationship concerns two dimensions, the length (e.g. in hours) and the structure (e.g. working in shifts or on demand) of individual working time. Points of reference may be daily, weekly, monthly, annual or life working time. Means to achieve working time flexibility in an employment relationship are as follows:

- variable working time regarding length and structure;
- flexi-time;
- working time accounts;
- overtime;
- working time corridors, which gives companies the possibility, within a certain limit, to reduce or to extend working time;
- job sharing;
- sabbatical leave;
- early and partial retirement;
- weekend work;
- part-time work;
- temporary work;
- parental/maternity leave;
- homeworking;
- telework.

3 Purpose of Implementation of Flexible Work Arrangements

3.1 Employer Perspective: The Flexible Firm

The idea of the flexible firm suggests that the firm is flexible in terms of its adaptability to expansion, contraction or change in the product markets. Among others, flexibility serves as means to improve productivity and to cut unit labour costs, to adjust to unpredictable fluctuations, and to allow for the introduction of new manning practices to match new technologies. The flexible firm involves the notions of financial (and pay) flexibility, functional flexibility (e.g. by multi-skilled employees), subcontracting, outsourcing and distancing strategies (employment relationships are replaced by commercial ones), and numerical flexibility.

The numerical flexibility of the firm concerns the firm's ability to adjust the level of labour inputs, employment and the wage bill to meet fluctuations. Practices include:

1) the use of additional or supplementary labour resources such as part timers, temporary workers or casual workers;
2) the alternation of working time patterns of existing labour resources.

For the firm, working time flexibility allows to increase the general flexibility of the organisation to adjust to unpredictable fluctuations. It may allow to detach the company's operating hours from the individual working hours. Furthermore, some flexibility models, e.g. working time accounts, avoid that working time is counted as overtime and thus the employers does not have to pay the regular overtime bonuses.

3.2 Employee Perspective: Time Sovereignty

From the employee perspective, flexible working time provides an opportunity for more individual "time sovereignty" which could help to organise working time more in relation to the individual needs and interests. Important issues in this respect are the individualisation and differentiation of employees' interest and the dependency of these interests on the respective situation in life. A further important perspective concerns gender and the reconciliation of family and work.

4 To Sum-up

To summarise, the theme of flexibility of work organisation is currently coming to the fore, with varying degrees of intensity, in all European countries. In some countries, the debate began as early as the late 1970s, while in, others the matter only really arose a few years ago. However, in almost all cases work flexibility is seen as an important topic for the future. The emergence of this new factor in collective bargaining can only be understood in the light of economic, technical and social changes over the past 25 years. Governments and social partners have had to adapt their analyses and strategies to this new issue, and as a result, there have been changes in the content of the rules framing the length and utilisation of working time, and also in the character of these rules, whether statutory or collectively agreed, compulsory or optional.

Although the situation varies a great deal from country to country, it must be emphasised that in the majority of them, procedures for gathering statistics and analysis provide only incomplete, disparate and piecemeal information on the processes of implementation of forms of flexible organisation of working time, on their content and on their results. Statistics on working time and collective bargaining usually correspond to traditional categories which do not enable the character and scope of innovations to be identified. Analytical work provides contradictory results, which disparate methodological approaches do not allow to be compared with one another. It would be desirable that, in an area in which major changes are already under way or just starting, relevant and comparable information should be put at the disposal of those involved (Jacques Freyssinet, IRES).

5 The Future

It is necessary briefly to consider what the effects will be if the management gurus who have predicted sweeping change in work organisation turn out to be right. What will the effects be in employee-resourcing terms if non-standard working become the norm and people too seriously cease to expect, or even to seek, long-term, full-time employment with a single employer, preferring instead to work on a self-employed consultancy basis for a number of clients? The straightforward answer is that there will be a need for employee-resourcing specialists to find ways of managing through or round some of the disadvantages associated with atypical working described above. However, there are other potential consequences too – some of which can already be observed in industries where there are lucrative freelancing opportunities for people with particular skills. Examples include computer programming, some branches of engineering and the provision of some specialised business service.

The most obvious result is increasing difficulty in finding people to undertake work at the rates of pay currently being offered. The organisation is thus faced with three options:

?? to accept that it is necessary to employ freelancers at whatever cost

?? to hire untrained staff and then to invest substantial amounts in training them

?? to compete more effectively in a tighter labour market, giving particular attention to the retention of valued staff.

For many organisations this will require fundamental changes in the approach taken towards employee resourcing. It will no longer be possible simply to assume that, if someone leaves, they can readily be replaced by another person with similar skills. In other words, it will be necessary for managers to accept, to a far greater extent than is often the case today, that competitive labour markets exist, and that they need to develop effective strategies for competing in those that are vital to the success and survival of their organisations. Secondly, there is a need to redefine the psychological contract that is developed with employees by fostering relationships that facilitate high trust but that are not expected by either side to last for a long period of time. This involves acknowledging that employees will have different expectations from employers. Instead of seeking furtherance of a career inside an organisation, they will be looking instead for opportunities to increase their employability. To attract and then to motivate the best, more attention will thus have to be given to skills acquisition and to finding opportunities for employees to deepen their experience.

A third possibility that arises if key labour markets become much tighter than they are at present, could be need to alter the perspective from which strategic business planning currently takes place. Instead of looking for product market opportunities and then devising employee-resourcing policies to permit their realisation, there will increasingly be a need to start the process by assessing the organisation's labour market position. Strategic planning would thus commence with questions being asked about the pool of staff and skills on which the organisation can draw. Product market strategies would then be based on the results of this analysis, rather than the other way round.

II Flexible work arrangements in Slovakia

1 Methodology

The research utilises structured questionnaires and semi-structured interviews covering the application of various types of flexibilities as well as the willingness of the employers of the employers and employees to participate in these schemes.

Within the research there were 1423 questionnaires sent out to 67 organisations of different sizes, different industries and different ownership as well as managers of 46 companies were interviewed. The returned questionnaires accounted for 62 %.

The only flexible form of work arrangements, which is consistently recorded and reported, proved to be flexi-time. The other forms were commented on in the interviews as being applied or planned to be implemented, however, no relevant recording was offered to provide reliable evidence on their implementation in the view of the ratios of such flexible arrangements versus regular traditional work arrangements. Thus, only qualitative evaluation of the research could be provided.

2 The Findings

The most common flexibility form appears to be flexi-time. The other forms – part-time and temporary contracts are mostly used for peripheral groups of various categories of employees, primarily in services and media. They – as it is mentioned above – include well-paid positions as well as those in less glamorous ones.

In addition, part-time and temporary contracts are used in probation period as well. The managers argued that these forms of flexibility facilitate the termination of the employment relationship and prevent from the potential conflicts and cut administrative procedures and costs necessary for appropriate termination of the employment contract. Telework as a flexible form has not been introduced by any of the contacted organisations.

2.1 Flexi time

In Slovakia the framework for utilising flexi-time is set by the Labour Code. It assumes that both the beginning and the end of the work shift is set by an employee within so-called daily, weekly or four-week working cycles while the obligatory daily spell of presence at work (minimum 5 hours) is established. The presence at work is at the employee's discretion. In the case of daily working cycle, the employee is obliged to work for a preset number of hours within a day (it is the same amount of hours every day)and flexibility relates just to the beginning and end of the working block. The weekly variation presets the number of hours to be worked weekly, but the number of working hours can vary daily. If the four-week working cycles are applied, the number of hours to be worked is based on the weekly figure multiplied by four. Here, a number of hours to work can be shifted also from one week to another.

The employer here benefits primarily from the fact that all out-of-work commitments of the employee can be covered outside the working hours.

While numerous employees use mass transportation to get to work, the general benefit of flexi-time can be seen also from the perspective of transportation organisation in large cities. On the other hand, if commuting depends on particular lines (buses, trains) and the employees cannot get to work otherwise, the employer will not have chance to introduce flexi-time. As mentioned above, flexi-time is difficult to implement in some industries, eg manufacturing. If it is introduced, it mostly applies to the back offices in companies. Nowadays, flexi-time is used in less than 10 companies (approx. 5,000 employees) in metal industries, mostly owned by German capital.

The implementation of flexi-time on the part of the employer relates mostly to the industries with predictable or unpredictable fluctuation of work loads. The predictable fluctuation of work load occurs in agriculture, forestry, construction and the like. The Labour Code allows for flexi-time arrangement in a longer horizon, i.e. four-week or yearly arrangement. It means that in the busy season the employees work longer hours or more days a week while in the troughs they work less hours or even less days.

Unpredictable fluctuation occurs when the employer is forced to react to the unpredictable demands of the environment, eg loss of orders or large number of new ones. This is mostly the case of subcontractors. Such a case is not covered by the Labour Code in force at present and therefore the situation can be solved partially just through flexi-time arrangement. In Slovakia, the German model of flexi-time application is used, mostly in the subcontracting companies of large automobile producers. Here, if the employee does not work the full number of working hours within a particular month, a bank of working hours is created with either plus or minus balance. The employee is paid as if they worked full monthly time in either case. If the employee worked more, as compensation they can utilise time off in the future when the work load is lower and vice versa. The zero balance must usually be reached within a year. Of course, the implementation of the model must observe the general provisions of the Labour Code, such as the maximum length of the work shift, rest between two shifts, obligatory days for rest etc.The disadvantage here is that the implementation of such a model cannot be covered by a general agreement (e.g. collective agreement), but is always part of the employer-employee contract/relationship. Thus, the relationship is not neutral. The employer is usually more powerful. While the employer lowers the costs related to overtime, the employee may experience even raise of the costs, eg for transportation or childcare. In addition, a conflict can emerge if the employer needs the employee to be at work at the same time when the employee is forced to take time off because of external commitments. Again, infrastructure can also has its say in the introduction of this model in some regions.

2.2 Part-time Work

The part-timer if not working more than 20 hours per week exercises the position as that of a full-timer under the terms and conditions of the current Labour Code of the Slovak Republic. It relates primarily to the contributions to the social funds (e.g. pension scheme, health insurance etc.). The only disadvantage seems to be job insecurity, while the employer can terminate the contract without any notice.

2.3 Temporary Work

The implementation of the temporary contract cannot exceed 3 years. The employer, even if decides to terminate the contract earlier, is obliged to pay the agreed-upon reward fully. This contract's disadvantage is that termporary workers are not considered as potentials in terms of training and career development. The other form of termporary work covers the contracts limited by 300 hours per year. In that case, the temporary worker is paid just for actually carried out work. This form is frequently utilised while there are no contributions to the funds and thus labour costs are substantially lower. There is no obligatory recording and reporting of such contracts and therefore they are frequently misused, e.g. by the unemployed who may acquire regular pay along social welfare, or by employers who are able to dovetail several temporary workers positions to cover a full-time position and simultaneously cut the obligatory payments.

Conclusion

As mentioned above, the most used flexible work organisation is flexi-time, part-time and temporary contracts are used primarily because of economic reasons, such as cutting costs, no need for contributions to social funds, no need for redundancy payments in the case of closing jobs/positions, remuneration includes only base pay, frequently it means just the minimum pay. From the cultural point of view, there is no surprise that telework has not been introduced yet. Moreover, low mobility of workforce and usage of mass transportation and its availability can influence the introduction of this or that flexible form in spite of the wish of employers or employees. The Labour Code and its restrictive character can influence the way how flexible forms can be utilised as well.

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Contact the Author for a list of References.

The Impact of Privatization on the Economic Reforms in the Kyrgyz Republic

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Abstract

This paper seeks to demonstrate that privatization, if well implemented, will have a positive impact on economic development and democracy. Privatization is presented as a process of transferring assets from the public sector to the private sector. The world privatization experience has shown that successful implementation of privatization creates an environment for stabilization and structural reforms. Over the longer term, there is a clear need to assist the Kyrgyz Republic to ensure that privatized enterprises have the opportunity to remain viable and grow, and respond to their shareholders. Without attention to corporate governance and increased corruption, privatized enterprises could miss opportunities, expose their reputations to greater risk, and find themselves at a competitive disadvantage. Under this arrangement, the country creates favorable conditions to attract foreign investments and will foster further privatization and impact successfully on the economic reforms as a whole.

Introduction

The policy of privatization is based on the idea that activities of enterprises being implemented under free market economy with equal competition and commercial approach are more effective than those within administration limitations and instructions. The market is considered to be the source of social economic progress, the level of which depends on how competition is encouraged to increase production and consumer services.

Notwithstanding the depth and scales of revolution in the area of privatization, it remains an obscure notion to the majority of population. Actually, privatization includes many different approaches, goals and results. Some authors point out a necessity of good reasoned and consistent steps on the way to privatization, which would match a carefully developed conception[i]. The authors emphasize that "low effectiveness of production and inevitability of privatization are obvious"[ii]. Further, analyzing role of privatization in implementation of economic reforms, the authors write that "denationalization and privatization are, for sure, powerful mechanisms, which can enable the country to obtain in a new image, transform into a new quality of social and economic organization"[iii].

The problem of privatization is presented in discussions of its advisability. While such discussions take place, it is pointed out that consequences of privatization often appear to be negative in terms of the nation's wellbeing and social justice. In other words, privatization results in unreasonable enrichment of a narrow circle of the population and pauperization of the majority of the society. Actually, it is true, but in a short-term aspect. If privatization is considered not as a quick action, but as a long term and very complex process of changes, over a long period of time, its final aim is creation of effective economic public system.

In 1992, the Kyrgyz Republic embarked a broad program of stabilization and structural reform, including price liberalization, mass privatization and liberalization of the trade regime. Most prices were liberalized with the removal of all direct and indirect price controls, and as for trade policy, all non-tariff barriers to exports and imports were removed. A mass privatization program has placed approximately 1000 primarily medium-sized and large enterprises and several thousand small businesses under private control.

In Kyrgyzstan, the mass privatization was conducted in the following way: the whole adult population was given privatization coupons on a free and equal base, with further rights to purchase apartments or exchange them for shares of state owned enterprises. The coupons were easy to trade. But the market prices of the coupons were very low. The price of 100 coupons was 1.22-1.35 soms, one coupon being approximately 0.0008 US$. Thus the distributed coupons equaled 0.625 US$ per capita in the Kyrgyz Republic. As a result, the coupons were not considered seriously by their owners.

This method was widely used in the Czech Republic, Romania, Poland, Russia and Byelorussia. Unlike other ways, it does not require financing, and it does not gain budget revenues. The main peculiarity of this method is that the privatization process is quick and socially acceptable by the population. But the weak point of it should be admitted: that is the fact that the real situation of enterprises after privatization remain the same with all its related problems: difficult financial situations, low profitability, out-dated technology, and insolvency.

According to our viewpoint, the difficult situation of the industrial sector is due to the following reasons:

First, lack of joint tax, financial, capital-credit and currency policy with the NIS;

Second, differences of law regulations which effect cooperation and direct relations of enterprises;

Third, lack of common price and customs policy;

Fourth, low effectiveness of the management system resulting in slow and poor decision making, inadequate control of decision making and irresponsibility of managers;

Fifth, permanent increase of price of energy, raw materials, materials, and spare parts, which have worsened the problem of the payment of balance;

Sixth, underassessment of the necessity of state regulation in order to study the conditions of the effective functioning of the economy.

For the period of January 1, 1991 to 1994, in the Kyrgyz Republic, 5168 enterprises were privatized: in the industrial sector – 324 units, agricultural sector – 319 units, construction sector – 307 units, transportation sector – 102 units, trade and public catering - 1756 units, public service – 1878 units, non-production sector –218 units. But since 1994 (the second phase of privatization) the correlation of privatized enterprises has changed in terms of the ways of privatization. Transformation into joint stock companies was most common, which reached 40 percent. As for purchase by employees, it was only 3,7 percent, and purchase by private business – 16,2 percent. This correlation of ways of privatization is due to the fact that by 1994 big plants, factories and enterprises remained unprivatized, and later were transformed into joint stock companies. The table below provides a breakdown of the privatized enterprises in the Kyrgyz Republic:

	1993	1994	1995
Industry	259	324	462
Consumer Services	1,811	1,878	1,899
Trade and Catering	1,616	1,756	1,801
Agriculture	235	319	342
Construction	232	307	390
Transport	82	102	136
Other branches	192	482	856
Total	4,428	5,168	5,895

Fig.1 PRIVATIZED ENTERPRISES IN THE KYRGYZ REPUBLIC, 1993-1995
Source: Kyrgyz State Statistics Committee, 1996.

In 1996 the private sector in the Kyrgyz Republic was 50 per cent of GDP. As for other Central Asian countries, it was 20 per cent in Tajikistan, 30 percent in Uzbekistan, 30 per cent in Turkmenistan and 30 per cent in Kazakhstan.

The market oriented reform policies implemented by the government over the past years have promoted multiple sources for competition in the Kyrgyz Republic. The demonopolization of specific sectors (such as transportation and agro-processing), including the dismemberment of formerly vertically and horizontally integrated state companies, has allowed for the creation of competing markets and the liquidation of non-viable firms. The lowering of tariffs to a flat 10 percent and the elimination of quotas and other non- tariff barriers have made imports an important element of priced discipline to domestic producers. Finally, the liberalization of major restrictions to internal trade and foreign investment have created incentives for private entry, and, therefore, to expand and develop new markets.

Despite these reform efforts, private sector growth has been hampered by a number of factors. Markets are small and dispersed, the cost structure is high and the number of risk-takers small. There are important sectors, still run by state owned monopolies, where competition could be an important source of private sector development. Little restructuring has taken place at most privatized enterprises, which remain largely under the control of the same managers that directed them as state-owned entities. Foreign investors, who could offer new technologies, modern management methods, and access to world markets, are presented in only a handful of companies, and the securities markets lack sufficient liquidity to facilitate ownership change. Many new commercial laws have been adopted , but the judicial system is weak and court decisions are often unenforceable, and licensing requirements are often excessive. The system of corporate taxation lacks many of the incentives necessary to stimulate growth. Coupled with managers' fear of outsiders and loss of control, these factors have contributed to the general lack of investment and growth in Kyrgyz firms. John Nellis emphasizes that ironically privatization's present reputation in many transition countries as a prime cause of increased corruption[iv]. Privatization, sometimes, was conducted in a bureaucratic, corrupted and 'broadly-giving-away-for-nothing' way. According to the Institute of Statistic Researchers, share of black economy was 3,2 per cent in 1993, 6,0 per cent in 1994, 10,3 % in 1997, 11,9 per cent in 1998 and 12,3 per cent in 1999[v].

In 1997, the financial situation of industrial enterprises remained unimproved. This, in its turn, has been due to low quality of management of enterprises, lack of really market management of enterprises. Many managers have no idea how to plan activities in market economy. They had " neither the ability to modernize the enterprise nor the market experience to cope in a competitive environment, nor the drive and vision to guide the radical restructuring often required improving enterprise performance"[vi]. Nothing has been done to renew the main production funds. No measures have been undertaken to improve financial situation of enterprises. All these result in low profits, big losses and financial problems.

The privatization process in the Kyrgyz Republic can be divided into four distinct phases:

Phase 1 1991-1993

This phase focused on establishing the legal framework and institutional infrastructure required to enable ownership of private property (other than land) and private enterprise. Land

reform began with 17,000 peasant farms and new agricultural cooperatives being formed from a number of state and collective farms.

This period also saw two principal approaches to the privatization of companies:

(1) A small-scale privatization program. By the end of 1993 more than 3,400 small-scale enterprises in retail trade, catering and services had been sold via cash auctions.

(2) A mass privatization program (MPP). The Kyrgyz mass privatization program was designed to encourage ownership by outside investors in order to stimulate rent restructuring of enterprises. Enterprise managers have, however, not only effectively maintained control of the majority of privatized firms, but have been able to increase their holdings since privatization. This is the result of the purchase of majority positions by enterprise managers directly from the state during the privatization process, or from other investors during the several years following privatization.

Special payments were issued, the amount each citizen received depending on employment records. The vouchers could be used to buy public housing or partial payment for the privatization of medium-scale or large enterprises. The percentage of equity of such enterprises reserved for sale for vouchers was determined on an individual basis, but could not be less than 24%.

Negative aspects of this phase:

This voucher program turned out to be an inefficient and restrictive instrument of mass privatization because:

(1) vouchers were not tradable and therefore had no market value

(2) vouchers distributed only a small percentage of the equity of individual enterprises and offered no opportunity for change in control and management

(3) vouchers were time-limited and most of them were not even used

Positive aspects of this phase of privatization:

(4) destroyed state monopoly in retail and services

(5) introduced competition

(6) eliminated deficit

Despite these positive aspects, they did not bring any decisive changes in ownership and control structures within the economy.

Phase 2 1994-1995

This phase began with the adaptation of a new privatization strategy, which brought about important changes.With some key exceptions, all medium and large scale enterprises (MLE) became immediately available for privatization. Private investors, Kyrgyz or foreign, were allowed to own up to 100% of the equity of the MLE.

The MPP vouchers, most of them still unused, were replaced by privatization coupons. Coupons could be used to purchase equity in state enterprises at coupon auctions where typically up to 25% of an enterprise's equity was offered. Coupons could also be used to buy the stated-owned dwelling in which the coupon holder lived. Coupons were transferable, and both Kyrgyz nationals and foreigners – including institutional investors – could trade freely in them.

In addition to the coupon auctions, individual privatization, cash auctions (which typically took place following an enterprise's coupon auction) and investment projects were the main methods of privatization used during this stage. Phase 2 also saw the creation of the Enterprise Restructuring and Resolution Agency (ERRA) in May 1994 under the World Bank- supported Privatization and Enterprise Sector Adjustment Credit (PESAC) to deal with 29 large loss-making enterprises. This group of companies needed either radical restructuring or liquidation. Diagnostic studies were conducted on each of the enterprises, and liquidation was begun in those determined to be unsalvageable. The ERRA shut down production at these enterprises, instituted "care and maintenance programs", and placed the bulk of their employees on paid leave. Within the group judged to be salvageable, there was restructuring to relieve the companies from the burden of old debts and non-core assets. Some received rehabilitation assistance in the form of loans from the PESAC program and have successfully resumed operations. One completely resuscitated after controlling blocks of shares were offered for sale by tender to strategic investors.

All told, phase 2 encompassed the complete or partial privatization of an additional 1,000 enterprises. Disposition of the 4,4 billion privatization coupons which were printed during this period has been as follows: 41.26% were used at auctions by individuals and companies; 9.82% were used at auctions by investment funds; 0.20% were used to purchase apartments; 0.72% were used to purchase property; 27.55% were distributed but remain uninvested; and 20.45% have yet to be distributed (as October 10, 1996).

The main objective of this stage of privatization was transformation of medium size and large enterprises in industry, transportation and construction. They were privatized in the following manner:

- 5% of the equity distributed to the employees
- 25% sold for coupons in auctions
- 70 % sold to individuals or corporate investors at cash auctions.

All these figures demonstrate there is a serious problem of "coupon overhang", which can be attributed to the following reasons:

(1) The MPP vouchers were time-limited and a proportion of the population lost their entitlement to convert them into coupons because they did not do so prior to their expiration date.

(2) The general population had little confidence in the values of the privatization coupons. At a current market price of 1.22 – 1.35 soms for a bill comprising 100 coupons, each coupon is worth approximately 0.0008 US$ making the distributed coupons equal to only 0.625 US$ per person in the Kyrgyz Republic.

(3) While the Government's motives for retaining a portion of the coupon issued are not known to the author, it is known that the government has periodically sold small groups of coupons into the market. At their current market price, 20% of the coupons which remain in Government hands are worth approximately $0.75million. However, each time a group of coupons is sold, the market price has fallen and effectively diluted the value of the outstanding

coupons held by Kyrgyz citizens. This auction effectively transferred part of the value of the Kyrgyz Republic's assets back into the hands of the State.

(4) A significant amount of the coupons in circulation remain uninvested. Thus, portions of those companies to be sold in phase 3 of the privatization program (see below) must be offered to the general public in exchange for the outstanding coupons; otherwise the uninvested coupons will be useless.

Phase 3 1996-1997

This phase focused on restructuring large objects of monopolized sectors of the economy, privatizing non productive spheres, and restructuring and rehabilitation work with heavily indebted enterprises by units of the State Property Fund. Phase 3 is distinguished from phase 2 by the nature of the companies involved, which are predominantly large scale enterprises in mining, construction, transport and tourism, public utilities and infrastructure. Also 100 MLE that had been partially privatized, but in which the government continues to retain significant share holdings.

Phase 4 1998-2000

The current stage of privatization lays emphasis on restructuring monopolies in the basic and strategic sectors of the economy – telecommunications, civil aviation, printing and publishing, electricity generation and distribution, coal mining, natural gas import and distribution, engineering, antimony production, natural gas import and distribution. Because of the size and diversity of these largest properties, there will be specific arrangements in every case. Each of the entities will be subject to thorough feasibility study.

Thus, the Center of International Private Entrepreneurship conducted the research on economic reforms in 32 countries, including all the main developing countries, as well as the former socialist countries of Central and Eastern Europe. The research has shown that those countries which successfully implemented privatization programs – Thailand, Malaysia, Singapore, Mexico, Argentina and Jamaica, have succeeded much in their reforms. But successful implementation of privatization programs does not necessarily result in successful economic reforms. The main point here is that successful privatization creates an environment for stabilization and structural reforms.

Although some degree of macroeconomic stability has been achieved by the government, the macroeconomic reality of the Kyrgyz Republic has yet to be improved to the levels necessary so that privatization and restructuring would be considered as a positive impact on the economic reforms.

Why is privatization an important element for economic reforms?

Privatization can improve the economy and create favorable conditions for local and foreign investors which are obligatory conditions of economic reforms at present. In other words, privatization is profitable for state and private sectors and consumers, not only for those enterprises being privatized.

Privatization will be successful if accompanied by reforms targeted to create more open and competitive markets. Despite economic difficulties, which are temporary, privatization is a huge step toward economic growth and lasting prosperity.

To draw foreign investment, notwithstanding the fact that in the direct perspective, privatization and implementation of economic reforms have a destabilizing impact, effective privatization programs can stabilize the monetary situation and economy of a country in the long perspective.

Macroeconomic stability is a key factor in drawing foreign investments, which bring many advantages to countries receiving investments, that is sharing technology, increasing employment and developing exports. These three aims are crucial for the economic growth and development.

The climate for foreign investments in the Kyrgyz Republic at the enterprise level is not ideal. Despite the adaptation of a foreign investment law that guarantees the rights of the foreign investor, enterprises have limited experience and interest in investment by foreigners. Owners frequently overestimate the value of their companies, not understanding the relatively high level of investment risk perceived by foreigners and the investment alternatives available to them in other markets, particularly as the "global market place" continues its expansion. Local managers and owners fear a loss of control and are reluctant to disclose enterprise information essential for investor analysis They are also unwilling to undertake the restructuring methods set by foreigners as conditions for investment.

Foreign investors and local managers alike bemoan the loss of tax holidays available under the old foreign investment law. Without the inclusion of compensatory investment incentives in the Tax Code, government officials continue to grant tax concessions and privileges in an effort to remain competitive in attracting foreign investment vis-a-vis neighboring countries.

Although the Kyrgyz Republic has entered into international trade agreements with its neighbors, enterprises report various difficulties in transporting goods across borders. Vehicles face frequent and extensive delays at border crossings and Custom Union countries often do not recognize duty-free entry of machinery and equipment in transit to the Kyrgyz Republic through their countries, or they require payment of VAT before goods are released. Companies complain of arbitrary enforcement and interpretation of rules at borders and claims of improper documentation. Transparent complaint and appeals procedures are lacking.

Weaknesses in the legal and judicial systems also hamper investment. Foreign investors as well as domestic investors demand control of enterprises in part due to the difficulties in adjudicating claims in the Kyrgyz Republic. While most major pieces of commercial legislation are now in place, enforcement of judges' decisions is difficult and a workable system of appeals non-existent. Courts suffer from a lack of transparency, poor procedural processes and the absence of qualified judges and other legal professionals. This is the result of poor training and low compensation. An honest court system is essential for encouraging and supporting the restructuring of enterprises, as the legal protection of the rights of creditors and other collateral holders, the enforcement of liquidation and bankruptcy rules and the guarantee of property rights are strong incentives for managers to put their houses in order.

Despite the adaptation of a licensing law in 1997, the system of enterprise licensing, in particular the lack of appropriate procedures for exacting penalties for violations or of a transparent appeals process, remains a source of harassment for firms. Abuses in the administration of licenses, frequent changes in government practice and criteria, and the recent proliferation of licensing requirements can provide significant power to officials to thwart the rational flow of business. The securities markets in the Kyrgyz Republic have played a limited role in fostering ownership change. Trading on the stock exchange is strictly regulated, but almost all trading takes place "off-market", in an unregulated environment fraught with potential risk, and the largest infrastructure companies most likely to attract investor interest have yet to be privatized. As a result, exchange liquidity is particularly low. For most people who became shareholders during the mass privatization program, opportunities to sell securities are limited.

Why has privatization implementation appeared to be difficult and contradictory?

Here four groups of reasons could be pointed out, which slow down the process of privatization:

(1) First, the policy of the opposition, which resists the process of privatization, presents a non-homogeneous environment, not supporting the policy of the government;

(2) Second, the private sector is not strong. Therefore, an inadequate level of financial markets, and laws, as well as on finance and poor credit and securities mechanisms badly effect privatization of large enterprises, the main way of which is share sales;

(3) Third, technical difficulties and large material expenses of privatization are common in developing former socialist countries, including the Kyrgyz Republic, with lack of both finance and highly qualified specialists to fulfill targeted projects;

(4) Fourth, conflicts in the aims and conditions of privatization itself.

For instance, in the Czech Republic, privatization received more support than in Poland and Hungary (where the process was considered as an encouragement of foreign investments). In other words, the Czech public was much more interested in privatization than was the public in Poland , since people had the choice of how to use their vouchers[vii]. Privatization in the Kyrgyz Republic showed, that bureaucracy, which comprises heads of former state owned enterprises, have too much impact by adopting forms of privatization to their own interests, or, as commonly said, they turn privatization into 'personal privatization' – "prihvatization".

The experience of privatization in the developing countries, for instance, in Thailand, Indonesia, Singapore, enables us to make a number of general conclusions concerning privatization:

?? introduction of competition in sectors, being monopolized by state owned enterprises in the past, enables large enterprises to be more effective and provide services of better quality;

?? private pension funds will assist in easing privatization processes since they strengthen capital market and enable individual share holders to manage their shares and participate in programs. Elements of this experience were used in the Czech Republic and Poland;

?? privatization programs are implemented faster if the state does not make attempts to reconstruct enterprises before putting them on sale. Private investors, as a rule, can take more effective measures of reconstruction. Delay of privatization causes doubts towards the government and decreases public support of privatization.

?? delay of privatization is costly for the state as well, which can cause or prolong misbalance on a macroeconomic level.

The result of this research enables me to make the following conclusions:

The world experience of privatization has shown that privatization, if well implemented, will have a positive impact on economic development and democracy.

The Kyrgyz Republic has made good progress in privatization compared to other types of reforms performed in the country. However, privatization program could have been even stronger. The degree of nepotism involved in the sale of companies needs to be reduced . The pace of privatization could be quickened and the quality improved if:

(1) Defined prices for international securities are on more realistic levels and time frames are longer.

(2) Government sells more companies on an "as-is' basis, and the object of restructuring (state debts, financial statements of enterprises) is prepared according to international standards, and the legal status of enterprises is clarified.

(3) Created rule of law and culture of honesty.

(4) Corruption is reduced.

(5) The policy of privatization is clearly defined and procedures followed more strictly and transparently.

(6) Created an adequate institutional framework that would include strong mechanisms of corporate governance, including rules to protect minority shareholders, rules against insider deals and conflicts of interest, and adequate accounting, auditing, and disclosure standards.

(7) Developed infrastructure.

(8) Opened an access to appropriate, sustainable technology.

Over the longer term, there is a clear need to assist the Kyrgyz Republic to ensure that the privatized enterprises have the opportunity to remain viable and to grow, and to respond to their shareholders. Programs to assist in restructuring newly private enterprises, developing capital markets and financial institutions, raising capital from foreign investors, and developing effective corporate governance will be the major components of that assistance. Without attention to corporate governance, privatized enterprises could miss opportunities, expose their reputations to greater risk, and find themselves at a competitive disadvantage. Ultimately they will become less attractive to foreign partners and investors. Privatization, if implemented effectively and in a well organized manner, evokes trust towards the government among potential capital investors inside and outside the country. This, in its turn, will foster further privatization and will impact successfully on the economic reforms as a whole.

References

Contact the Author for a list of references.

End Notes

Contact the Author for a list of end notes.

Electricity Sector Reforms in Transitional Economies with Specific Reference to Latin America and India

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Abstract

There are significant differences between the electricity industry restructuring in the advanced economies of the West and the 'reforms' that are carried out in the transitional economies like those of Latin America and India. While competition and consumer interest is the focus of the former, privatisation and investor interest is the focus of the latter.

Introduction

Electricity sector reforms have had different reasons for their coming about in different countries. In the USA it was because of what Paul Joskow called 'price gap', i.e. different prices prevailing in different States [Joskow 1997]. Here the industries in the high priced States wanted freedom to shop around from States where the price was lower. Thus the focus was on wholesale competition. In the UK it was based on the premise that 'government should not be in business'. The Coal miners' strike also helped the resolve of the Thatcher Government. The focus was on privatisation, though they took care to introduce competition simultaneously.

Initially there was pool-based competition and later it was dominantly based on bilateral contracts with the pool serving the residual market. However in the transitional economies the 'reforms' were more or less force-fed and were not always to be advantage of those economies. Here privatisation rather than competition was the dominant theme, since the consultants regarded that these countries were not yet fit for competition. In the Latin American case this meant predominantly US multi national companies buying up State owned firms in electricity generation and distribution, some times at manipulated low prices[1]. In the Indian case also they started with independent power producers (IPPs) at the generation end, after unbundling the integrated State Owned Utilities (SOU) and introduced what is called a 'single buyer model'. In this all the IPPs were to sell their electricity forcibly to the single transmission company, which was a State owned entity.

Because the IPP power was very high and because the buyer entity was near bankrupt, the model failed. Now the World Bank and its consultants are switching to privatisation of distribution. Unlike in the Latin American case, in India there is not much interest among foreign investors in managing distribution, because (1) distribution is a much more messy affair having span over a very large region some of which may be geographically as big as a smaller country, (2) it is more difficult to extract high margins, since part of the existing inefficiency of the SOUs was offset by low wage costs and (3) so far no one has figured out a way to handle the agriculture sector consumer in rural areas which consumes about 30-40% of the total power and highly subsidized under the public sector regime.

The present paper discusses the motivation for reforms and the methodology of reforms in both Latin America and India and offers some possible lessons.

Motivation for Reforms

According to International Energy Agency's forecasts, electricity demand in OECD countries had reached a plateau at 3% growth and two-thirds of the incremental demand was to come from the developing countries, notably from China and India. This lead to a scenario of visualizing the power market, with North as the supplier of equipment and South as the consumer.

The equipment had to be sold and also the payment received. Reforms, seen in this context, would be to create market for power equipment to satisfy the demands, and tariff reforms to make the buyer of equipment a financially viable entity. Such an agenda then automatically gives primacy to opening up the generation, rather than deal with the cancer of corruption and inefficiency at the distribution end. Distribution reforms are also messier, requiring political will to confront engineer's associations and an area where the foreign investor is much less interested.

Thus the reforms started at the generation end. From the Indian side, the motivation for reform was that the demand was growing at about 9% requiring installation of additional capacity of the order of 50 GW and in an environment of wanting to control the fiscal deficit, the Government was looking for private sector involvement in meeting this expansion target. On the distribution side, each State Government was subsidizing the SOU of about US$ 300 to 400 million partly for subsidizing rural electrification but mainly to cover the huge losses due to theft incurred by the SOUs.

Indian Electricity Reforms

The Bank started the reforms with the State of Orissa. The rationale of choosing Orissa was that it was not stymied by the agriculture tariff subsidy problem with only about 10% of energy being supplied to agriculture as against 30 to 40% in other States. Secondly, it was also likely to have less opposition from the staff unions, since most of the engineers were in fact from the Government and hence statutorily immune to job loss fears.

The motions of unbundling, corporatization and setting up of the regulatory body were gone through. In the first instance, distribution was given to private sector on a management contract, as a prelude to privatization and also to test the waters. This turned out to be a failure as enhancement of revenue by plugging the leakages, did not materialize. As a result, the Gridco, the State owned transmission utility, cancelled the contract with the private sector, midway. The main reasons for failure were: improper specification of the contract, management's lack of control over employees, and the inherent lack of incentive in a management contract to make investments for loss reduction. Undaunted, the Bank counseled outright privatization—selling 51% of shares-- of the distribution zones. Coincidentally the same BSES of Mumbai with whom the management contract was abrogated, was awarded 3 zones and AES, an US firm, the remaining zone.

AES took that zone as it was also an Independent Power Producer (IPP) in that area and it thought that control over distribution would mitigate some of the payment risks in generation. Later AES realized to its chagrin that unbundling generation, transmission and distribution, with a public sector Gridco in between would annul this advantage of payment risk mitigation. The privatization process was marked by insufficient investor interest, with only three bidders finally submitting the bid [Sinha 2001].

The main reasons for insufficient investor appetite cited by the consultant (Frontier Economics) were: high level of losses and collection risk; problems of inherited staff; low size of the system that that could not support the estimates of fixed costs (eg. 3 to 4 expatriate employees in India); tariff uncertainty (the regulator never made clear what investment would be allowed under the rate base for earning returns); poor information from Government of Orissa and GRIDCO and returns being too low for the risk. It is interesting to note that investors did not see the big losses as opportunity for better returns through improvements, which is the basic argument for privatisation.

During the operations for 1999-2000 and 2000-01, all the privatized Distcos were making losses. More importantly, private sector has not been able to achieve what it was supposed it would, viz. plugging of leaks. Ratio of billing to input energy was only 56%, implying that 44% of the input power was not billed. In addition, the ratio of collection to billing was only about 77%. To be sure, there was improvement in efficiency, but the pace of improvement was below expectation.

The private sector discovered that the actual losses were even higher than the losses assumed at the time of bidding. Tariffs based on low T&D loss bench marks were inadequate for the distribution companies to cover their costs and earn a return. There is also the possibility, that the Distcos may not have the incentive to declare the improvement, even if they do improve, since gaming the situation would yield them greater tariffs from the regulator. There was a systemic flaw here in regulation. Unlike in the UK where they follow an incentive regulation, with a cap on price increase percentage given by (RPI – X) along with a review period of 5 years, during which the utility has an incentive to reduce costs and make improvements, the Indian regulators have adopted a cost plus guaranteed return based pricing, which is determined each year, thus totally giving no incentive for the utility to make improvements. The more zealous the regulator is to pass on the benefit of improvement immediately to the consumers, the more information asymmetry he has vis-à-vis the regulated, the more s/he is likely to lose the purpose for which s/he set about.

The power sector problems in Orissa reached such a pass that AES, one of the private sector partner of Distco, threatened to withdraw from the company, since its generator IPP was not getting paid by GRIDCO. The OERC, fearing an emergency situation, had stripped AES of the management control of the Distco and vested it with two government nominated IAS officials.

The World Bank's reason for privatization was the belief that it would improve performance by reducing the T&D losses, based on evidence of lower loss figures for *existing* private sector distribution licencees in Mumbai, Calcutta and Ahmedabad. But in the case of Orissa they failed to reckon that privatizing the Public Sector is quite different from having the Private Sector ab initio.

The new management under private sector is finding the task of improving collection a daunting challenge and overcoming the corruption inertia takes a while. This is because, the whole incentive system is based on the philosophy that the person in charge of distribution would return a Re.1 revenue to the firm for a 10 to 15 paise incentive for him. But as the privatized managements may have found out, this does not apply to those who are chronically used to covet the full One Rupee without any fear of consequences. As Nigel Lawson [1992] famously remarked on the impossibility of restructuring the public sector: `you cannot change a mule into zebra by painting stripes on its back.'

In Karnataka the reform consultants faced a similar problem, viz. lack of investor interest in distribution privatisation. To overcome this, they have come up with a new formulation called "Distribution Margin" concept. According to this, the private sector will not take the revenue risk, but the distribution company will get a payment that will cover its cost plus a return on its investment and this payment they will take it as the first charge on revenue.

The return on investment will be low initially corresponding to the present level of T&D losses. For any improvement, there will be additional incentive payment, thus improving the return. The eventual deficit that will occur when payment is to be made to the generator will have to be borne by the Government, in the hope that this deficit will fall over time, with improvement in losses.

The biggest flaw, which is in fact claimed as its virtue, is that the normal business risk in revenue collection which the distribution firm is best able to handle, is now removed from it and passed on to the Government, with no corresponding guarantee from them as to when they will show improvement. This is, in short, privatisation of public sector theft! In addition, the consultants are coaxing the regulator for a multi year tariffs, to remove regulatory uncertainty, but the regulatory commission is (rightly) not agreeing, since at present they are at a tremendous information disadvantage.

In Haryana, the reform was started with a $600 million bill, with the consultant (National Economic Research Associates, US) chanted the same mantras of unbundling, corporatization, privatisation and setting up of regulatory body, but not introduction of even wholesale competition. The Bank made one innovation in its lending here. They came up with a new Adjustable Lending Programme, whereby the project was broken up into several milestones and completion of each milestone, made the borrower eligible for the next tranche of loan. [Mostefai (1998)]. The process saved the borrower from embarrassment in case he is not able to proceed with the reform mandate.

The prophecy was self fulfilling, and after availing of $60 million, the Government withdrew from the reform programme over the issue of increasing the electricity price for farmers. 'Since then, the Government has chartered its own course of reforms and shown quite a few systemic improvements (though critics claim these are on paper only)'[Powerline (2002)]. They have unbundled, but not privatized. If the official claims are true, the Haryana example suggests that governance—read, a kick in the pants—works where incentives fail. A determined and formidable lady Government officer with a couple of engineers as colleagues Managing Directors has reduced losses (i.e. theft) by resorting to technology and management control. We have an apparently paradoxical situation here, where States like Uttar Pradesh and Karnataka are going through the motions of reform, getting ticks on a

World Bank's check list, but without any improvement whatsoever, and only increasing the transaction costs, and Haryana which is labeled as having backed out of reforms, but embarking on substantial and real reforms.

Another recent example in the improvement of SOUs is the Andhra Pradesh Central Discom where again the engineer Managing Director from Haryana was brought to this discom and he has reduced the losses by about 12% in two years through IT enabled services, offered by World Bank loan and with Multinational consultants. Three lessons on this: (1) It is the governance rather than ownership which is vitally important. (2) It is possible to have good governance under public management also, though this cannot be either designed or guaranteed. For instance, the same ITES were offered to other discoms also in Andhra Pradesh, but the CEOs of those discoms did not take the help. (3) It is always better to improve the SOU before selling, to realize a higher value, but most of the time the improvements will not come through system changes but only by a change in the CEO.

In all the other States where electricity 'reform' is on, there is unbundling, corporatization and regulator in place, but without distribution privatization and without any sign of competition. The Bank seems to be following what is known as the 'single buyer model' with all the generators including IPPs being forced to sell to a single buyer, viz. the State Electricity Board or its corporatized avatar the GRIDCO, all of whom are uniformly bankrupt. Even the Electricity Bill 2001 vests with the regulator the discretion to decide as to when to permit the generator to sell power to any one other than the SEB. This is done with the sole interest of protecting the SEBs who earn the cross subsidy by overcharging the industry, (i.e. other than those, in industry, whom they undercharge for a consideration).

The present situation of partial, more specifically half baked, reforms is actually worse than under central planning, because under the earlier regime investment and pricing were neatly decoupled, with financial losses not affecting generation expansion, being funded from Central Government and with Bank assistance, optimal location and mix decisions being taken exogenously by the Central Electricity Authority which enunciated such policies like pithead power generation in large scale by Central sector plants, discouraging small scale and captive plants which did not enjoy economies of scale etc. The World Bank's *project based* approach helped 'provide 13 loans and 3 credits to help the National Thermal Power Corporation (NTPC) rapidly expand generation capacity and become the largest generator in India.'(OED 2001).

With the shift in Bank's emphasis to *sector based* approach, and with partial reforms in place, the central government's budgetary investment is drying up, along with funding from the World Bank; the NTPC which was a low cost producer all along as a central Government PSU, and was once the favorite borrower of the Bank, has no funds for expansion , but wants parity in returns with the IPPs, with no parity in risks; the IPP's want an unaffordable price for their power for they face severe payment risks from the sole buyer SEB; and with increasing input power costs and continuing revenue leakage in distribution, the SEB's are breaking down. The World Bank should hardly take credit for what it has done to India's power sector.

Progress on 'reforms' is measured on the parameters: SOU restructuring, constitution of the State Electricity Regulatory Commission, Commercialization of Distribution as a prelude to privatisation, reduction of cross subsidy and Memorandum of Understanding with the Central Government. In the absence of the political will to privatize and lack of enough number of entrepreneurs coming to bid for distribution privatisation the intermediate steps involve enormous transaction cost and appear wasteful.

For instance, under the Bank's tutilage, the Karnataka Power Transmission Corporation Ltd. gave a 'capacity building' contract to one Multinational consulting firm, for Rs.14 crores ($.3 million), and Privatization consultancy to another multinational firm for a similar amount. In the Delhi distribution privatisation case, a recent World Bank study by Agarwal, Alexander and Tannenbaum [2003] concludes that SOUs cannot be improved and hence 'capacity building' is a waste of money; as regards privatization KPTCL was told that private sector would not be interested unless the Government gives various guarantees. But then one of the conditionalities of the World Bank is that the State must agree to spend if the State wants the bigger amount of money for the hardware portion of 'reforms'. Yet the Bank's internal auditor (OED 2001a) applauds its efforts in the sector saying :

> "OED strongly supports the South Asia Region's strategy for the energy sector, initiated in 1993, that concentrated all its power sector resources into promoting SEB structural reform and only financed distribution system upgrading. The strategy is highly commendable for its relevance to India's development objectives, its efficacy in rehabilitating a critically weakened

sector, its efficiency in use of Bank resources, and its mobilization of private sector resources (where are they?). In the light of the radical institutional changes that are being implemented, the reform is likely to be sustainable. OED deems this a best practice model that should be emulated throughout the Bank's energy sector portfolio".

On the whole, the Banks' attempts at power sector reforms are not yielding results. The only sound advise that stands out is their refusing to approve Enron's Dabhol project on the grounds that importing gas is inferior to making use of domestic coal and that Maharashtra grid may not be able to absorb the 2000 MW of Dabhol power without injuring itself. World Bank itself possibly has greater knowledge and intimacy with the Indian power sector than the consultants appointed by them. Perhaps they could have done a better job if they had taken up the task themselves than entrusting piecemeal to different consultants, one for each State, which totally missed out the benefits of wholesale trading.

While there has been unbundling, corporatization and appointment of regulators, almost in all SOUs in India, and the new Electricity Act (2003) has provided for open access and wholesale competition the latter have not yet come into existence. Thus the benefit of reform in terms of competition in generation has not been achieved in India.

The benefits due to privatisation are not yet ready to be measured. What is clear is that distribution privatisation has not attracted abundant investor interest either internationally or nationally and in Delhi where it has been done, a heavy price has been paid by writing off liabilities of SOU by 85% from a total liability of US$. 4.6 billion, and further promising Government subsidy to the transco US$ 690 million over a 5 year period.

Latin American Privatization

The AAT [2003] study cites the example of Latin American distribution privatisation where the regulators set a multi year tariff (MYT) in the beginning of privatisation, and also provided for full taking of benefits when the discoms beat the targets of performance, in effect adopting the (RPI – X) type of regulation, as in the UK. The benefits will pass on to the consumers at the end of the tariff period when the regulator will set new values of X based on past performance.

In India, the regulators, in general, seem to insist on an yearly review based on cost of service regulation and do not agree for MYT because of serious data problems which prevent them from setting MYT on any rational basis. It is also true that being newly appointed to these statutory positions, they want to use the power of regulation tending to over-regulate. But then, the Latin American case of setting an MYT and taking no share in the (excess) benefit may virtually amount to writing a blank cheque for the discoms. Whether these regulators have sufficient information to set these MYTs fairly tightly is a point to be considered.

In the Latin American case, one sees a large diversity. In Argentina the regulators are chosen by public contest and public hearing is important. In Bolivia also the regulators are appointed by the Country's senate and there is political independence. But in Columbia and Chile the regulator is under government control. In Argentina wholesale competition brought down the prices. In Bolivia and Columbia still a significant share of generation was traded in the contract market where efficiency is not clearly provable[2].

Conclusion

The main thrust of this paper is to suggest that the reform priests have often one set of rules for the developed countries and another for transitional economies, not just because the different rules are more appropriate but because of a wide variety of extraneous considerations. Thus it is in the countries' own interest to make use of the think tanks in their respective countries and arrive at optimal policy decisions.

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[2] For instance the distribution company at Sao Paulo was sold at an unexpectedly low price to AES. Later Financial Times' investigation revealed that AES had persuaded Enron to drop out on the eve of tender opening. [Agarwal, Alexander and Tannenbaum 2003]
[2] Even though the recent BETTA model of UK is also based on assuming that bilateral contracts definitionally are efficient, being arrived with the consent of two parties, there can be problems in this assumption for transitional economies since both parties may not have equal bargaining power and option to exit.

Public Private Partnerships (PPP) in Pharmaceuticals:
A Shift toward Hybrid Forms of Governance

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Abstract

The contribution presents Public Private Partnerships (PPP) as key tools in the valorization, both from an individual and from a collective perspective, of the revolutions undergoing in the pharmaceutical sector. They lie at the core of the processes of production of knowledge and insure the accumulation and the diffusion of the advances achieved in the field of the biotechnologies. But they gathered together a large variety of actors, with differentiated when not opposed incentives and objectives. Successful PPP thus imply to activate coordination mechanisms able to establish stable compromises. Using the conceptual tool of the "cities", derived from the Economics of conventions, the paper stresses the peculiarities of those modes of governance and the main domains on which they are challenged to produce an hybridization of cooperative and competitive modes of interaction.

Introduction

In the pharmaceutical sector, the increase in the production of scientific knowledge (due both to genomic advances and an extensive use of ITs) goes along with a clear dynamic of overlapping of the academic and market-oriented objectives, associated with an hybridization of knowledge (Carayol, 1999, Gibbons et al., 1994). It blurs in particular the distinction between fundamental knowledge and knowledge supporting market activities.

In that perspective, fundamental research is not just a way for a firm to reinforce absorptive capacities (Mowery, 1983, Cohen & Levinthal, 1989). The output of this kind of research can be sold. Conversely, universities can generate knowledge through forms of targeted research, and directly incorporate those outputs into other processes of production of knowledge (furthermore, universities are more and more faced with a strong financial constraint, which can be partly solved by going on the market).

There is herein a fascinating paradox. Universities and public research centers, which were used to be the exclusive producers of scientific knowledge, are now faced to new forms of competition, as private actors challenge them. But at the same time, because of the specialization of the learning trajectories, and the need to recombine complex pieces of knowledge, the interdependencies are reinforced; public research needs results produced on the market side, and vice versa.

The multiplication of Public-Private Partnerships (PPP) and the raise of new collective modes of knowledge production have been underlined in the literature (Shinn 1999, Callon 1995, Gibbons and al. 1994, among many others). Nevertheless, the dominant view about university/industry relationships generally emphasizes the difficulties to implement PPP by opposing two clearly contrasted worlds_ submitted to differentiated objectives and values. On the one hand, the industrial actors produce knowledge, driven by commercial interests. On the other hand the logic of academic science and basic research is described as a quest for truth in the processes of accumulation of knowledge (Buchbinder & Newson, 1985; Slaughter & Leslie, 1997). Such a dichotomy implies strong differences in the behavioral norms, especially with regard to the disclosure of knowledge (Arora & Gambardella, 1997), or to the feature of the reward system (Dasgupta & David, 1994).

We adopt in the paper a slightly different position. The aim is to explore deeper the features of the "co-opetitive" interactions between public and private actors, the "unavoidable necessity" of such partnerships being largely admitted through the literature. Looking to the pharmaceutical sector, the contribution tends to demonstrate that if conflicts exist in PPP, they are more related to a lack in terms ot coordination devices, rather than to intrinsic and irreducible differences between the protagonists of the cooperation (Mailhot, 2003. Mailhot & Mesny, 2002). In particular, the diversity of the output of the research processes, and the complex and contextual nature of knowledge (Ancori and al., 2000) imply to mobilize simultaneously several competencies, differentiated spaces of negotiation and different modes of legitimization. We claim that, because the diverse and heterogeneous incentives and rationales of the public and private actors at least partially converge, the knowledge production regimes need to mix different types of coordination mechanisms and issue on hybrid forms of governance (Joly, 2001). The question thus bears on how to coordinate distributed pieces of knowledge - i.e. how to solve knowledge asymmetries in a perspective of creation of resources- instead of focusing on the sole information asymmetries and the eventual optimality of the allocation process.

The pharmaceutical sector stands actually at the crossroads, and is compelled to exploit the new opportunities provided by the rise of biotechnology (section 1). Referring to previous works (Bureth, 2002, 2003), we claim that new discoveries in molecular biology, even if they have not modified the nature of the scientific output, drastically affect the organization of the R&D processes. They have smoothed some of the "traditional" oppositions evoked in the literature on innovation - market based vs. science based approaches, demand pulled vs. technological pushed developments, fundamental vs. applied research processes, etc (section 2). But the most salient feature is the certainly the width and the intensity of the interactions induced by the collective nature of the research processes (section 3).

In such a context of intense collaboration undertaken under high competitive pressures, PPP appear as a keystone of the process of innovation. They bring together the largest range of interests, and are real triggers of the scientific knowledge production (section 4). But PPP also concentrate conflicts, due to the encountering of differentiated actors. We draw uppon the work of French conventional ists Boltanski & Thevenot (1987, 1991), as well as Boltanski & Chiapello (1999) and extend their approach in order to identify the diversity at stake within PPP (section 5). It leads us to identity three main sources of conflicts, and to explore the conditions for achieving stable compromises between the different logics mobilized by heterogeneous actors.

1. The Pharmaceutical sector: between fear and hope

Even if it still exhibits attractive ratios of profitability, the pharmaceutical sector is actually faced to heavy crisis factors. Three problems at least have been largely underlined by the analysts: there is firstly an urgent need to renew the portfolio of products. Thereafter, decreasing returns in the traditional research methods, based on "discovery by serendipity", limit the opportunities of innovation. Finally, the sector has to deal simultaneously with an increase in R&D costs and a drop of market returns. By 2005, half of the hundred most prescribed drugs in the world, representing about 30 billion dollars of annual sales, will fall into the public domain (Serusclat, 1999). Considering the specific structures and strategies of the sector, the impact of the losses of patents is significant. Due to high R&D costs, pharmaceutical firms rely on a handful of flagship products: the blockbusters'. For instance, Prilosec® (patent expired in 2000) represented 39.8% of AstraZenecca's global turnover; 26% of Eli Lilly's turnover was generated by the famous Prozac® (patent expired in 2001) (Hamdouche & Depret, 2001). The entrance of generic drugs on the market rapidly and dramatically erode the position of the pioneers (Beynon, 2000, Sellers, 2002). And the consequences are not circumscribed to sales values; for instance. when Wall Street was informed that Eli Lilly could not extend its patent on Prozac®, its shares suddenly decreased by 30%.

But the changes in the pharmaceutical industry are not only induced by the need to renew the portfolio of products. Some contributions have underlined the decrease of productivity in pharmaceutical R&D processes. It is particularly noticeable in the methods of identification of molecules suitable for the production of new drugs (Drews 2000). Traditionally, the way to obtain new drugs relies on two parallel investigation processes. First, research aims at identifying new molecules (using the so-called methods of deductive design. random drug design, random screening, blind screening). The second part of the job is to find out the fields of application of a candidate molecule, by assessing its properties, its toxicity and its related side effects. But such processes based on "discovery by serendipity" (Drews 2000, Quirke 2001) exhibit strong limits. If in the early sixties, a new drug was selected on the average basis of 3000 synthesized molecules, 10000 candidates were needed some ten years later (Dumoulin 1994). Drews and Ryser (1997) emphasized a clear limitation in the variety of the therapeutic targets. In the US, the National Institute for Health Care Management (NIHCM) stated that out of 857 new applications authorized by the Food and Druc Administration in the 90s, only 311 of them were new molecules. In terms of products. Serusclat (1999) indicated that 62 new drugs were launched in 1987, 37 in 1996 and 47 in 1997. A third salient feature of the sector is the tremendous increase of the costs of R&D combined with the drop of market returns. The average cost to develop a new drug is estimated between 500 and 800 millions dollars (Serusclat, 1999, Hamdouch & Depret, 2001, Tollman et al., 2001). The average development time fluctuates between 12 and 15 years. But at the same time, fewer and fewer products are able to cover their development costs (Glover, 2002). Consequently, no actor is able to support alone the risks of the research and the financial weight of such projects. This aspect is reinforced by the low concentration of the sector: despite intensive external growth operations, only three groups (GlaxoSmithKline, Pfizer and Merck) achieve worldwide market shares over 5%. Finally, the competitive pressure leads the pharmaceutical groups to devote more resources to advertising. The situation can thus be roughly described as follows: the value of R&D expenses is increasing in volume, but decreasing in relative shares, expressing that marketing strategies more and more often dominate innovation strategies.

In opposition to the difficulties evoked above, the pharmaceutical sector has benefited in the last two decades from huge opportunities opened by the development of genomics and recombinant DNA technology (Gambardella, 1995, MacKelvey, 1995, Henderson et al. 1998, Galambos and Sturchio, 1998). The bio technological revolution has produced (and the process is still going on) scientific results that have largely pushed further the comprehension of the mechanisms governing diseases.

Hence new solutions have emerged (at least from a theoretical perspective) in terms of treatment, detection and prevention of diseases. 50% of the new drugs are already linked to biotechnologies, and 90% of the biotech firms are acting in the pharmaceutical field or in related technologies (Lenoir, 2002). 16% of the drugs are produced by biopharming - pharmaceutical products are produced by plants or animals programmed genetically. And the efficiency of biopharming over the traditional synthesis techniques is estimated at a factor 1000 (Pastor, 2003). Till the end of the decade, the markets in which Life Science and Biotechnology are involved could represent more than 2000 billions of dollars (Tollman et al., 2001).

2. New constraints in the organization of R&D processes

Nevertheless, notwithstanding a drastic evolution of concepts, genomics has not modified the content of Science or the output of R&D processes, but has deeply transformed the way research is conducted and organized.

A first point is a progressive change from "D&R" to "R&D" processes. The formulation is somewhat excessive, but expresses the reversal occurring in the relation between Science and industrial applications. In the bio-chemical paradigm, Science is often considered as resulting from problems encountered in the production field (Rosenberg 1990). The discovery of a molecule using random screening methods is the starting point of the scientific process addressing its properties. As stated by Hitchings (1980), " Much of the basic research supported by industry is, in a sense, retrospective. A semi-empirical discovery of a useful drug provides the stimulus for deeper probing into how and why it works, and thus to a deeper understanding of the underlying disease. This may in turn give rise to new concepts and new discoveries " (Hitchings, 1980, p167).

The discovery of the DNA structure by Watson and Crick in 1953 paved the way to a powerful stream of research identifying the biochemical and molecular mechanisms hidden beyond the observable symptoms of diseases. This is quite different from discovering an active substance. By highlighting general properties and building theoretical models, Genomics has replaced Science upstream: the conceptualization of the structure of a molecule is now based on the causes of human disorders, the properties of chemical components and their impact on organisms (Hamdouche and Depret, 2001).

A second rupture can be observed in the organization of the research processes. Until the late 70s, research in Biology was essentially fundamental and conducted by academics under public financing. In 1976, the foundation of the first biotech firm, Genentech, by Herbert Boyer, is the beginning of an important trend of firms creation by researchers.

Knowledge is actually produced in structures mixing public and private actors, multinational firms and start-ups, with very close relations to the domestic and the financial markets. Extensive development and use of ICTs have largely supported those changes. By increasing the throughputs of research, by lowering the costs of experimentation, ICTs provide increasing returns in the constitution of genomic data banks (Nightingale, 2000). The combination of scientific advances, identifying new fields to be explored, and the rise of technological tools, providing strong exploration capabilities, have pushed firms (and especially New Biotechnology Firms) toward specialization trajectories in the production of knowledge. ICTs also favor the exchange of, and the accessibility to data, and provides furthermore the possibility to control those exchanges. Henceforth an important consequence derived from advances in genomics is the creation of markets of genomic and genetic knowledge. Because knowledge produced in research processes can as such be sold, market and upstream research become more and more interwoven, and generate intricate and highly uncertain innovation patterns.

Classifying the actors of the sector following the distinctive criteria of information production, technology development and product manufacturing is less and less relevant. As seen by Orsenigo et al (2001), "two main search regimes have started to coexist within the industry. The first regime is essentially based on biological hypothesizes and molecules that tend to be specific to given fields of application (co-specialized technologies), while the second regime is characterized by the emergence of new generic tools (transversal technologies)" (ibid. p488). But under both regimes, the actors are often simultaneously producing knowledge, using/improving technologies, and incorporating knowledge and technology into products.

If we refer to the representation of the chain-linked model proposed by Kline and Rosenberg (1986), innovation is not built upon interactions between functions (research, marketing, production, distribution) performed by correspondingly specialized actors, but rather between actors covering several of the innovation functions within a specialized domain of application.

The consequence is an extension of the competition far beyond the traditional market borders. Research undertaken in the pharmaceutical sector often gathers the willingness to develop a practical application and the need to improve the comprehension of some fundamental mechanisms. Such mixed research objectives generate strong tensions (Foray, 2000), expressed clearly in the use of Intellectual Property Rights. IPR are more and more averted from their initial function - to reward an innovator - and become strategic devices activated in order to lock competitors. There is herein an important risk, especially for a knowledge intensive sector like the pharmaceutical sector. The cumulative and sequential nature of the whole innovation process can collapse (or at least the costs for the innovators of the second generation can greatly increase) because of patents initially taken by a first mover to protect his market

Following the brief description given previously, the pharmaceutical sector is mainly characterized by a "co-opetitive" context, in which every actor is compelled to co-operate with potential competitors. As heavily underlined by Depret and Hamdouch (2000), the economy of the genome which seems to emerge nowadays implies a radical re-definition of the pharmaceutical markets and a renewed industrial organization, both in terms of management of the innovation processes and in terms of technological and competitive relations between the actors. The capacity of those actors to promote efficient scientific and industrial collaborations will determine how the economic and therapeutic potential of genomics will be made real in the coming years.

3. The need for and the implications of collective modes of production of knowledge

The evolution of the pharmaceutical sector, driven by advances in biotechnology, has multiplied the actors and their links, through various forms of cooperation, agreements and partnerships. But the reinforcement of the intangible nature of the output of the research and innovation processes has also dramatically complexified the organization of those interactions.

For instance, in the traditional schumpeterian model the incentives to innovate rely on the possibility for the innovator to enjoy monopolistic returns at the product level, and this argument seems to be highly relevant in the pharmaceutical sector (Coombs & Metcalfe, 2002). Nevertheless, it also raises difficult questions when the innovation product is "new knowledge", as in pharmaceuticals.

A piece of knowledge -a new gene for instance- can be used by several actors, for different purposes or further developments of Science. Concerning DNA and proteins patenting, there is a subtle balance to find out, between encouraging innovation and stifling research. Protecting the innovator without inhibiting further research implies thus the creation of contextual rules and local coordination procedures, generally implemented in cooperation devices.

To the same extent, a patent on an industrial process is generally applied to a defined field of activity. Concerning biotechnologies, the processes involved in the production of scientific knowledge are often transverse and are applied by agents pursuing different objectives. To give an example, biochips can be applied to fundamental research (proteomics, sequencing) or to commercial applications (drug design, diagnosis). Affymetrix (owned by G1axoWellcome and Bristol Myers Squibb) is the main producer of biochips, and locks the market of that basic technology using its patents. Furthermore, Affymetrix does not produce chips to meet demand, but collaborates to what it considers relevant and interesting scientific projects (Serusclat, 1999). There is thus a clear threat to impact on the production of knowledge in many different fields following the strategic options of one single actor. Here again, the problem has to be solved through specific coordination procedures and regulation principles, allowing or compelling the patent owner to adapt his behavior. As claimed by Binns (2001), such an issue is outside the ambit of patent law; "a patent gives its owner the right to prevent use of the patented invention by others, but it does not constitute approval for the patent owner to use the invention" (Binns, 2001, p274).

The traditional pharmaceutical industry was producing drugs. The rise of biotechnology has oriented the activity toward the production of an explanation of the mechanisms of life, issuing on new solutions in terms of diagnosis, prevention and treatment of existing or potential diseases (Hamdouch & Depret, 2001). It goes far beyond the sole technical perspective of the therapeutic approach, and raises ethical, sociological and economic questions. In other words, the pharmaceutical improvements and their impact on public health bear on some general concerns which can not only be assumed by the scientific or professional community. The globalization of the interests related to pharmaceutical innovations appears clearly in the multiplication and the ever-growing' phenomenon of regrouping of the actors involved in the production of scientific knowledge.

R&D processes heavily rely on collaborations, partnerships, cooperative agreements (Feldman & Hopkins 2001 for a survey of the studies on pharmaceutical agreements). The biotechnological sector exhibits the highest rate of creation of alliances (Hagedoorn, 1993). Fisher (1996) registered more than 20 000 agreements, with a 25% growth rate per year. In 1994, the 10 biggest pharmaceutical firms externalized 4% of their R&D expenses. This share soared to 30% in 2000 (Serusclat, 1999). In other words, pharmaceutical innovation is fully a collective process of invention despite of a strong competitive context.

But the pharmaceutical labs are part of integrated networks including more than just industrial partners of the sector. The patients are considered as products and services consumers, and act through associations and groups of pressure. Pension funds, institutional investors. agro-food or micro-electronic industrials are seemingly part of the network. As stated by Hamdouch and Depret (2001), the new environment of the pharmaceutical industry is more unstable and uncertain than ever. The overlapping and the telescoping of scientifical, industrial, financial and ethical logics reduce the visibility of the actors. Some principles have to be constructed in an environment without pre-established norms, even if endowed with heavy legal constraints.

Whatever the issue under discussion - intellectual property rights, diffusion of knowledge, conditions of competition - the question of how to achieve and to rule the cooperation is constantly raised. Following Callon, the question is all the more crucial as i) the role of each actor is not clearly defined, and ii) some of the actors are groups and not individual agents. In such a context, "it is vitally important that public and private sector discussion, engagement, and partnership are raised to a global level" (Ridley & Roberts, 2001, p79). The present contribution aims at insisting upon the concerns related to the public-private interface in the pharmaceutical field. We assume that it is the privileged vector to reconcile the private and the collective interests, to manage the risks at a collective level by creating independent expertise capabilities, and to avoid a myopic valorization of extremely radical innovations.

4. "Why are conflicts within PPP so important and where do they come from"

We have tried to emphasize above some of the outstanding features in the recent evolution of the pharmaceutical sector. The advance made in molecular biology and genetics in the sixties have triggered intense collaboration between universities and industries m the late seventies. At that period of time, when the industry became aware of the commercial potentials opened by advances in biotechnology. they were unable to exploit the research results using their in-house research capabilitiesil. In order to fill up the gap and to diffuse the new biotechnology knowledge, industry supported (and government encouraged) in the eighties the creation of biotech firms founded by university researchers. As outlined by Dalpe (2003, p176), "the expectation was that the pattern would shift over time because industry was supposed to gradually internalize the creation of new knowledge (Orsenigo, 1989, Pisano et al., 1988, Zucker and Darby, 1997)". But the trend did not decrease, and the universities still play an important role considering innovations and commercial developments.

Bodin and Gingras (2000)lll show an increase by 155% of the collaborations of universities with industries, hospitals and government laboratories from 1980 to 1995. 2/3 of the collaborations are dedicated to the fields of clinical medicine, biology and biomedical research. Seemingly, Arora and Gambardella (1994) notice the upholding of the number of strategic alliances between large pharmaceutical firms and public research organizations. Almost all leading biotechnology universities are linked to firms (Zucker et al., 1995). Movery et al. (2001) highlight an increase in biotech academic patenting related to market opportunities.

The situation in Life Science is thus unique, although some feature are shared by other sectors, like ITs (Kenney, 1986). The sector is highly "co-opetitive" (Brandenburger and Nalebuff, 1996), and all the actors are simultaneously using competitive and collaborative strategies in a knowledge driven business environment. "Co-opetition is exercised through the formation of "value-nets", where the firm interacts with suppliers, customers, competitors and complementors to maximize its own added value through managed relationships with other players in the net" (Carayannis etal., 2000, p478). The concept of co-opetition can even be extended, especially regarding biotechnologies, to other levels of the actors' strategic environment. As proposed by Carayannis et al. (1997) in their "bull's eve framework", there is a need of mixing competitive and cooperative relations at the market level, but also at the political level (between firms and institutional actors) and at the ecological level (between firms and their industry ecosystem). In other words, competitiveness and innovation capabilities - both from the individual or from the collective point of view - are dependent from the participation in networks gathering together "broad, diverse communities of players who must become intimate parts of a far-reaching process of co-evolution" (Moore, 1996, p61). Without being exhaustive, such extended networks include university researchers belonging to different disciplinary fields, small biotechnology firms, large pharmaceutical firms, hospitals, as well as venture capital, law firms, chemical or microelectronics firms, consumers associations, regulation institutions, governments, actors from the stock market. "Such large networks are a prerequisite for risky and very costly projects, such as the development of new drugs representing a major shift from current medical practices and which need regulatory approval" (Dalpe, 2003, p182).

The dynamic of those networks lies at the heart of new patterns in the innovation patterns. As claimed by Arora, Gambardella and Rullani (1997), knowledge production capabilities are enhanced, specialization is reinforced, and the locus of innovation may be spread across heterogeneous agents. But at the same time, such complex systems bring together differentiated preferences and objectives. heterogeneous norms, conflicting interests, and entail problems in terms of opportunistic behaviors and costs of coordination. Solving internal conflicts can also issue on problems in terms of fitness'" of the whole system: multiplying "conflicting compromises" may prevent the network from attaining an optimal configuration (Schilling, 2000) In that context, PPP appears as keystones of the collective innovation process. First, they are at the core of the production of new knowledge, insofar as the university researchers still seems to be the main source of knowledge, despite a diversification of the loci of production. Second, they are the privileged form to achieve "learning alliances" (Doz, 1996)", within which scientific knowledge is exchanged against expertise in production, management and commercialization. Third, they are the place in which economic and social concerns encounter. This last point is in our view especially important: indeed, as long as the processes of hybridization between market and science increase and become more and more irreversible, they leave the delimited space of the economics of science to become central objects of the public debate (Hamdouch and Depret, 2001).

PPP are important instruments to innovate. But their output can not be assessed under the sole market rules. Because they are involving public resources, i.e. a collective investment, they should generate some collective returns. Treating cancer for instance cannot only be interpreted as a demand or a supply expressed on the health market: it also corresponds, even before the product exists, respectively to a right or a duty. This latter aspect has to be defended by the public actors, representative of and relaying the collective interests. Pharmaceutical discoveries generate important risk and/or uncertainties which can not be managed, neither only under market forces. nor following the sole sound science. There must be room for the authority of science, for a democratic participation of the public, for independent administrative regulators (Joly, 2001). PPP are the tools to create mixed expertise capabilities, by benefiting from distributed knowledge and controversial assessment processes. Those mixed expertise capabilities are necessary to feed the construction of efficient regulatory frames, in which the policy maker is faced to what David (1986) called the "narrow policy windows paradox"" and the "blind giants quandary"". PPP are thus privileged support for policy decision-making, insofar as they are mainly focused on fundamental research. Sustainable innovation implies to integrate some long run perspectives in the processes of valorization of discoveries. The importance given to the property rights system in the sector raises the question of intergenerational spillovers (Scotchmer, 1991). Patents protecting a discovery can deter further innovation. There is thus a need for adapted patenting behavior, considering the breadth and the length of the patents not only in terms of immediate profitability, but also in terms of incentives to innovate when research is cumulative"". The latter perspective should be more easily taken in account by public actors holding property rights, partly because seeking for profitability is not the main concern of the public research, but also because "patents on government sponsored research rewards successful innovators twice, once through government funding and again through the patents" (Scotchmer, 1991, p40). In other words, the aim of implementing PPP is not only to produce and to diffuse valuable knowledge for innovating on markets. There are related issues in terms of regulation, following economic, scientific and ethical considerations. Joining academia and industry is in our view the best way to constitute robust expertise capabilities, obeying simultaneously to criteria of scientific quality, of economic efficiency and of independence. Nevertheless, following Morris (2000), "the constitution and governance of such jointly tunded bodies need to be carefully drawn up so as to provide the benefits of partnership without losing independence of judgment, or falling into the murky ground of conflict of interest" (Morris, 2000, p164). PPP obviously gather together actors following different sets of norms, The opposition made famous by Dasgupta and David (1994) between the Republic of Science and the Realm of Technology" clearly points out the difficulties raised by such forms of collaboration. For instance, the degree of codification of knowledge - which impinge upon the intensity of exchanges and interactions - expresses different ways of coordinating and organizing collaborations, different representations of expertise, different incentives schemes and reward modes. Nevertheless, by emphasizing heavily the opposition between fundamental and applied research, the new Economy of Science underestimates the "gray zone" (Hamdouch and Depret, 2001, Callon and Foray, 1997) where science and market are overlapping. One of the conclusions of David and Dasgupta (1994) was to recognize the benefit for the society to obtain scientific outputs using two distinct channels, despite of the irreducible tensions existing between them. "Indeed, we will argue that in order to ensure a reasonably efficient allocation of resources in the production of knowledge, modern societies need to have both communities firmly in place, and attend to maintaining a synergetic equilibrium between them" (Dasgupta and David, 1994, p519). Especially in the pharmaceutical field, that equilibrium is more and more replaced by complex interactions. And the reasons exposed above are pleading in favor of a further intensification of those interactions. Our understanding of the biotech sector implies to take some distance with a dichotomize lecture in analyzing PPP. As convenient as it might be, viewing academic science and industry as two worlds relying on opposite rationales is at best a convenient simplification. We aim at exploring how an organizational device can cross (and not only host) different sets of incentives and interests. To the same extent, we assume the existence of points of convergence, shared by actors from different communities. We will draw upon the work of Boltanski & Thevenot (1987, 1991), who have identified `cities', which correspond to the various ways a person, an action, a decision, an object, an organization - including, thus, a public/private partnership - can be situated, justified and legitimated. Those conceptual tools are useful m identify the different logics at stake within partnerships, and pave the way to discuss why and how seemingly differentiated actors can collaborate and interact.

5. PPP as hybrid organizational object and mode of governance

The collective nature of the knowledge production in the pharmaceutical field endorses a variety of organizational constructions. Among all the forms of collaborations, PPP exhibit strong peculiarities. More than other forms of collaboration, PPP imply to find ways of collaborating despite different and sometimes contradictory interests. Within industry (as within academia), partners share at least a context and some behavioral rules or norms. In the course of the co-operation, conflicts might arouse because of asymmetries of information, opportunistic behaviours, and differentiated objectives. The resolution of such divergences will be at least facilitated by the existence of a kind of shared culture. In the case ot PPP, the differences are apparently much more salient, and exist from the very beginning. The following table sums up the features of academic science and industry assumed in most of the literature about the new forms of partnerships between universities and firms (Mailhot and Mesny, 2002):

TABLE 1 : LOGIC OF INDUSTRY VS. LOGIC OF ACADEMIA (source: Mailhot & Mesny, 2002)

Industry/Technology	**Article I. University/Science**
Development and commercialization of applied knowledge in order to produce technological artifacts	Production of abstract knowledge and basic research
Logic of heteronomy (norms: efficiency, control, etc.)	Logic of autonomy (norms: freedom, auto-control, etc.)
Logic of efficiency: search for the optimum return on investment consistent with stable growth.	Logic of discovery: the pursuit of knowledge is more important than the development of products.
Knowledge as a private good: protection of information and knowledge	Knowledge as a public resource: diffusion of knowledge
Market evaluation (criteria: time-to-market, cost, quality)	Peer evaluation (criteria: methodology)
Search for immediate profits, attainment of specific goals for a particular company or industry	Search for long-term gains for the benefit of the society, fulfillment of altruistic ends

Because of, and through the bringing together of actors belonging to contrasted worlds, the output of PPP overflow the frame of their exploitation by the involved partners. As we have seen previously, PPP are mainly dedicated to the production of knowledge liable to feed the cumulative process of innovation. They thus generate important spillover effects. They also are a melting pot to create improved expertise capabilities. Beside positive effects, autors have equally pinpointed some dangers. The debate about new forms of collaboration between industry and university often boils down to wondering how `impure' science can become, and if the dangers of this `hybridization process' do not far exceed its benefits (Slaughter & Leslie, 1997). Increasing funding of academic research by industry `may alter the norms and values of the scientific community' (Arora & Gambardella, 1997: GS). For example, the scientific community might become less open, might try to protect more forcefully its information and behave more like rent-seeking firms. Conflicts in PPP thus appear to be unavoidable. But hence, the resolution of those conflicts strongly impacts on the global innovation trajectory of the sector. In other words, PPP involve the construction of durable compromises, made viable through hybrid coordination mechanisms which, in our view, can be grasped through the work of French conventional ists Boltanski & Thevenot (1987. 1991). Although these authors do not directly address the issue of science and technology, their typology of forms of legitimacy can be used and extended in order to shed light on the hybridization mechanisms taking place within PPP. Boltanski and Thevenot (1987, 1991) address the long-lasting issue of how actors with divergent interests manage to cooperate (Amblard et al., 1996). They assume that a durable agreement always implies a common framework, or a `convention', under which actors can conceive, discuss and solve problems. Partners might disagree upon particular solutions and assertions, but they need an agreement upon a general representation frame delimiting the scope for decision and action. The focus is thus placed on situations in which collaborations are implemented between actors referring to a priori different frames. In our view, PPP precisely corresponds to this sort of situation, in which actors call upon differenciated forms of legitimacy in order to promote their interests and to reach an agreement (Mailhot & Mesny, 2002). In the biotechnological sector, we have argued elsewhere that the multiplication of data and scientific knowledge also implies the production of associated forms of meta-knowledge (Ancori et al, 2000, Bureth, 2002). Meta-knowledge refers to general and universal issues expressed in questions such as: what kind of knowledge should be develop and why'? for whom should that knowledge be develop and what objectives will be pursued`? Such a questioning leads the actors to develop general conceptions of science and to explicitly discuss the features of the link between science and industry. The use we make of Boltanski and Thevenot' typology aims at identifying the forms of legitimacy at stake in PPP, the conception of science they carry, and the conditions required to bridge them. Boltanski and Thevenot' typology is build on seven `cities', which correspond to the seven forms of legitimacy that are used in out - modern society, namely the inspired city [cite inspiree], the domestic city [cite doncestique], the city of opinion [cite de l'opuzioy, the civic city [cite civique], the industrial city [cite uidustr-ielle], and the merchant city [cite rnarcharrde]. Each city is a `world' in itself, with its objects, its subjects, specific types of relations between them, its ruling, etc. For reasons of space, we shall not detail here each city. The following table sums up their main characteristics:

TABLE 2 : THE SEVEN CITIES

	Founding principle	**Investment Formula**	**Repertories of subjects and objects**	**Relations between subjects**
Inspired City	Burst of inspiration	To question, to risk,	Subjects: artists, children, monsters, Objects: the unconscious, dreams, spirit	Creating, discovering, imagining, searching
Domestic City	Tradition, generation, hierarchy. The development and preservation of science as a distinct sphere	To serve, to be in harmony. To defend science and its autonomy form the rest of society, to dedicate oneself	Subjects: parents and children, chief Objects: good manners, gifts, titles, ranks. Member of a scientific community, peers, scientific methodology	Reproducing, educating, to criticize, to form, peers relationship
City of opinion	The others, the public, Public recognition by the international scientific community	To reveal, disclose, to give up secrecy. Submitting manuscripts, asking for financial support from big funding institutions, participating to congresses	Subjects: celebrities, leaders of public opinion, spokesperson Objects: messages, campaigns, trademarks Scientific with a good reputation, publication and citations.	Persuading, influencing, convincing, propagating., citing
Civic City	Precedence of the collective, general will	Solidarity, struggles	Subjects: representatives, public, public communities and organizations Objects: rights, legislation, procedures, codes	Mobilizing, excluding, debating, speaking, informing
Merchant City	Rivalry, competition	Freedom, detachment	Subjects: seller, buyer Objects: valuable goods	Buying, selling, paying, competing
Industrial City	Performance, efficiency, the future	Progress, investment	Subjects: expert, specialist Objects: tool, plans, resources, methods, tasks	Analyzing, measuring, implementing
Project-oriented city	Activity, projects, proliferation of links. Proliferation of scientific networks and research projects	Adaptability, flexibility, tolerance, lightness. To put oneself on an equal footing with others, to tolerate uncertainty, to be open	Subjects: mediator, coach, expert, project leaders, innovator Objects: new technologies, accords, meshes of net	Connecting, communicating, trusting, adjusting

Depending to which city a situation refers, modes of coordination can be very different. Our societies, however, increasingly implies `composite situations', in which two or more cities or orders of justification can be called upon. People routinely deal with situations that pertain to various logics of justification, and they have to switch from one world to the other. Neither a person, nor a situation, is `attached' a priori to one particular city. This plurality of forms of legitimacy implies conflicts, disputes, and compromises.

A compromise, in this perspective, consists in a certain `mix' or a trade-off between the different forms of legitimacy. It will last in time through the mobilization of objects and/or the implementation of specific modes of coordination.

Referring to the above typology, firms and universities are composite organizations relying on several and differentiated cities. Turning more specifically to the pharmaceutical sector, three "basic" types of actors can be distinguished. The Big Pharmas can partly be viewed as a form of compromise between the industrial city, the merchant city and, to a lesser extent, the domestic city. New biotech firms combine the project-oriented city, the industrial city, the merchant city, and the inspired city, whereas the traditional university is based on a compromise between the inspired city, the civic city and the domestic city. Based on our interpretation of the literature, the hypothetical picture we are proposing here can be largely discussed, and obviously reduces reality. But it matches relatively well the result we get out from the first few interviews we have conducted within the BioValley Network, and constitutes a starting point for further research.

PPP are themselves composite objects and a response to the new imperatives of cooperation that feature the recent evolution of science and technology. They are supposed to embody compromises between science and market, hierarchy and autonomy, etc. These compromises, however, do not seem to have reached a durable character, and have not so far led to robust procedures and modes of coordination that can be used at large in PPP (Riley, 2001). This perspective allows us to take further distance from the dichotomic vision proposed by the new economy o science. First, we cannot attribute a unique logic to an organization. It means that, if in the worlds of science and technology for instance, some driving rules are significantly different, some others are common, or at least partially shared (Hamdouch and Depret, 2001). The academic scientist, as well as the private enterprise, discloses the results of its work in order to satisfy its own interests (reputation, financing, social status for the former, monopoly return or licensing revenues for the latter). Identically, the competition between research teams exists both in the field of research (run for patents and/or to standardization) or in the field of science (run for the earliest publication). Second, benefiting from interactions between the cities does not mean that one city has to be submitted to the rules of the other. In other words, a positive cross fertilization between market and science will not be obtained by pushing science toward the market: It can be obtain throughout non-conflicting objects or throughout coordination mechanisms producing compromises, on the basis of which the participant's action registers are really linked.

The capacity to recognise the cities at stake within collaboration is a necessary step for reaching agreement and finding compromises. One of the benefit of the city model is to study the "ways of possible compromises" (Boltanski and Thevenot, 1987 : 246) between different worlds and to see how, practically, theses compromises that "enable the linkage between people and resources that belong to different logics" (Derouet, 1989 : 12) are built and maintained.

6. Some leading forms of compromises

The previous section assumes that common interest in technical or market developments will not level the differences in the legitimate ways actors refer to, in conduct research. But it assumes also that collaboration neither implies a common perception. The co-ordination must be ensured by common principals and shared processes allowing the regulation of the collective decision. Those processes allow the stabilization of an association without calling to an ex-ante order, and allow implementing collaboration devices without the existence of a consensus upon the content. We try thus to push further the social network approach, in which collaboration and the quality of interactions basically rely on trust and the accumulation of "social capital".

Three situations can be distinguished. First, the situation can be confined within one particular city, in which case disputes can generally be solved by referring to the founding principles of the city. We believe this situation refers to most of inter-organization partnerships, such as partnerships with competitors or suppliers, which can fairly easily be confined within the merchant and the industrial cities, whose principles can be accommodated in numerous forms of compromises which have long been solidified.

The second case refers to situations that cannot be confined within a particular city or an established hybrid combination between two cities. These situations, however, do not necessarily lead to conflict. The juxtaposition of several cities can be managed smoothly if forms of coordination inside each city are found which do not meet each other or only meet through non-conflicting objects or subjects. This case applies, for example, to forms of industry / university alliances in which roles are clearly separated, and industry representatives do not intervene at all in the research process.

The third case corresponds to the situation in which the harmonious separation of situations cannot be achieved. The juxtaposition of several cities within the collaboration leads to confrontation and conflict. An agreement has to be found, which can be local and transitory, or take the form of a long lasting compromise. If the latter situation is certainly the most valuable, only few cases of stable and durable compromises exist. Concerning PPP in the pharmaceutical sector, they are mainly embodied in the implementation of intellectual property rights. But a lot of forms remain still to be "invented", by the development of objects and material tools such as proprietary contracts, research financing, research processes, commercialisation tests of product research, criterions of science significance and risk assessment, etc.

Concerning the conflicting situation, we will not review extensively all the forms of compromises existing in PPP. But we tackle three of them, which are in our view the most challenging to explore (FIG.3). The confrontation between the industrial and the inspired city generates conflicts, insofar as the production of fundamental knowledge is not used to deal with constraints like cost, prices, timing, or efficiency. But establishing a compromise issues on fruitful results, and improves performances of both scientific production and product design. The merchant and the inspired city are opposing immediate profitability to long run creation processes. Here again, finding' a compromise impacts heavily on the trajectory of the whole sector, by improving the sustainability and the quality of the cumulative innovation process. Bridging the inspired and the civic city is the third type of compromise we want to emphasize. Consequences of such a non-resolved conflict is clearly observable in the agro-food industry, where the reluctance of the public jeopardizes the potential of development opened by the introduction of GMO.

It is worthwhile to notice that the achievement of compromises will be favored by the existence of some over-lapping in the orders of legitimacy used by the actors.

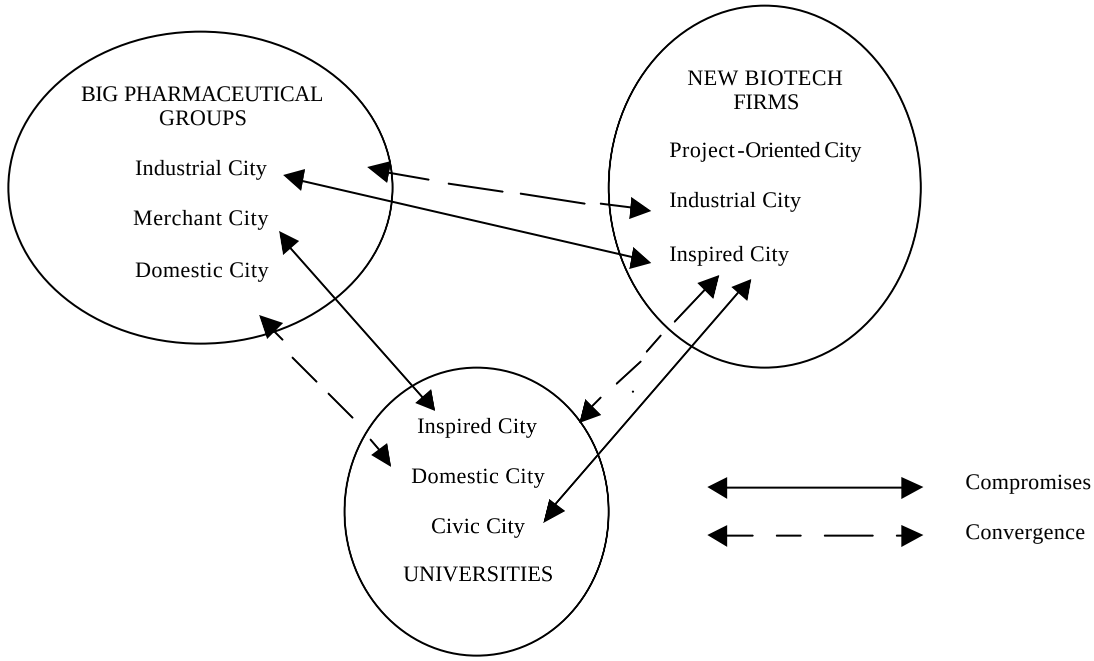

FIGURE 3 : THE CITIES DRIVING THE ACTORS OF THE PHARMACEUTICAL SECTOR

A first compromise at the base of the PPPs is the one that engages the inspired field and the industrial world (with the notion of learning) and that links the notion of efficiency with the promotion of creativity and energy. The scenario of passage from the discovery to efficient innovation depends on this form of compromise. The R&D processes in the field of biotechnology is greatly maintained by science, more precisely by the bringing out of general proprieties and the construct of theoretical models. It requires the participation of university researchers that are still the main sources of knowledge. The inspired logic, implying discoveries and risk, must be mobilized in the construct of these research processes. As such, in the PPP, research methods based on " discovery by serendipity " must be reconsidered.

The technological platforms developed by the biotechnology firms improve the research processes, by reducing costs and obtaining economies of scale (Nightingale, 2000), by limiting scientific dead ends, and more generally, by increasing the productivity of exploration processes. But all those scientific tools and research technics will support creativity depending on their users. Because the research in the field must simultaneously target practical applications and the understanding of fundamental mechanisms, there is a need of hybrid human capital, involving scientist aware of the market constraints.

We assume that a sustainable compromise depends from the mobility of the scientists from the academia to firms (mainly biotech firms) and vice versa. Dalpe (2003) shows very clearly that one of the strength of the US system is the possibility for scientists to enter in businesses without leaving the academic community. Our own interviews have confirmed that point: for instance, several interlocutors have underlined the need for an assessment, under academic criteria, of the scientific production done in small firms. The lack ot recognition by the academic community hinders the transfer of scientists in firms.

On the long run, it also implies to rethink the education process of the scientists, by introducing topics related to management.

There is also a compromise to be find between the inspired logic and the merchant world. It opens the discussion about the "creative market", and the favourable usage of the science's creative potential (even if risky) in order to create business deals, innovations, and to make profit (to deliver socio-economic profits and to get better positioning in the global market). This compromise derives from the recognition of the increasing costs of research, where no players can support alone the cost of project development. Within the research partnership, "business logic" must be combined with the world of inspiration, i.e. partners must achieve a business deal giving credit to creativity and discovery. Cassier (1997) well demonstrates that the integration of science and market raises the question of exclusive appropriation of data. The researchers must find different solutions of compromise to this problem using local partnership that they will establish with the industry.

Managing compromise thus implies to tackle the dilemma raised by the Intellectual Property Rights system. On the one hand, protection of intellectual property is a necessary condition to maintain incentives to invest in research. But on the other hand, the increase of property rights causes dangerous frictions and bottlenecks in a sector in which innovation relies, more than elsewhere, on collective processes of invention".

An extension of the practices of patenting seems necessary to preserve the sequenciality of the innovation processes. A first possible improvement is to clarify the distinction between the primary objective of the patent, the attribution of an invention, and the right to use that invention". Another possibility is to develop the protection by disclosing. The costs of the IPR system have led some small firms to publish their results on the Internet. The recognition of their innovation is granted by disclosing it as far as possible. A softening of the conditions of use of the patent can also be considered, by defining conditions of "fair-use", clubs of users or pools of patents (Cassier & Foray, 1999). Third the questions of patenting living organisms, methodologies and algorithms are still unresolved (Coriat & Orsi, 2001, Orsi & Moatti, 2001). Finally, there is a need to develop hybrid systems of public and private sponsorship (mixing grants or prizes and property rights), when they are dedicated to the production of "big science" (Maurer and Scotchmer, 2004).

Because of the width of the impact of pharmaceutical advances, in terms of risk, public health, economic development, the compromise between the inspired world and the civic world is necessary. The transition between these two logics is a matter of orchestrating the construction of the civic link by efficient methods of mobilization preserving however the multiplicity of the interests, the experience and the competencies of the principal concerned parties. In other terms, PPP must be equipped with co-operation devices where the sum of the interests and the views of all the concerned parties are represented allowing negotiation and conjoint construct of coordination objects.

Small technology firms often establish, for example, scientific advisory boards to evaluate the quality of research. In the case of PPPs, we have seen that the research must be assess against scientific criterions and also economic, social, ethic, and against the risks for public safety. It raises the question of the creation of councils able to gather and to preserve in their core, the multiplicity of the interests of all concerned parties by these major innovations.

Callon and al. (2001) get interested, for example, in the cooperation between profanes and scientist by studying "hybrid forums" aimed at solving conflicts about technological and scientific developments. For the authors, the success of hybrid forums depends on the development of tangible dialogic procedures that implies equity in the access to the debate, the transparency and the clarity of the rules that structure that debate. Such procedures imply a real openness, time and autonomy in order to forge local arrangements and ensure that each partner acknowledges the research and consider it as valid. These hybrid forums constitutes therefore networks of knowledge and action. They establish a collective expertise that is accomplished by the combination of a construct of scientific and technical knowledge. the consideration of sociologic and economic stakes, and at last, by the negotiation of work methodology (Lascoume, 2001).

Such expertise capabilities are crucial in our view. Because knowledge is very rapidly encapsulated in processes of economic creation, its management and assessment must include some ethical considerations, an appreciation of its related risks of misuse and of the conditions of distribution of its collective returns. Expertise does not only encompasses an objective validation of the quality of knowledge, but includes a prospective dimension and an assessment ability of the future consequences of potential developments. It modifies deeply the very nature of expertise, which is not anymore limited to an appreciation of the state of the art, but goes beyond that frontier to insure a type of mediation between the producers and the consumers/users of knowledge.

In that respect, the pharmaceutical sector is very peculiar. Because they rely on scientific discovery, innovative products arrive on the market following the technology-push mode. But because those products impact on the physical integrity of the consumers, the innovation process remains largely market pulled. Indeed, a new molecule, a new therapeutic protocol, and even a new research program must meet with social acceptance, from the financial, technical, cultural and ethical point of view. To adjust demand and supply is quite delicate, because of the ever-growing knowledge gap between producers and consumers. It follows that the management of innovation calls for experts able to attest the harmlessness of innovation. Expertise is not only a matter of technical capabilities (useful for the innovator), but relies also on the credibility and the independence of the expert, perceived by non-specialists. It raises the question of the status of academic public research centers. Their perceived and commonly admitted authority is liable to collapse because of their increasing involvement in market activities. The point is far from being marginal, as it can induce a contraction of the markets for the whole sector if potential consumers react negatively towards innovations.

Conclusion

The links between science and industry, and between science and technology have a long history which can be viewed as a process of gradual complexification. Behind the multiplication of PPP lies the intention of breaking away from a linear model of innovation in which the boundaries between science and society were clear and were based on powerful logics of justification. The analysis presented in this paper suggests that this rupture from a linear and bipolar model is not yet achieved. Hybrid conceptions of science and technology, the capacities to mix private and collective interests, the institutional, legal and physical devices mobilized for the management of PPP are still to be created. The recognition of the plurality of forms of legitimacy, upon which both academia and industry actors draw, induces a renewed conception of the relationship between science and industry that still is in a process of gestation and emergence. We have focussed on PPP as hybrid and composite organizations. It enabled us to question the broadly accepted view that firms on one side, and academic actors on the other, rely each on a peculiar logic, that tends to clash with the other. We assume that this dichotomy masks a plurality of logics or modes of legitimacy. The identification of those different logics, and the rules they embody, allows to locate the conflicts, but highlights also some grounds for compromises (that could not be apparent in the dichotomic view) and helps to identify the objects able to support governance mechanisms. Far from appearing only as a conflicts arena, the PPP are also described as important areas generating expertise capabilities obeying simultaneously to criteria of scientific quality, of economic efficiency and of independence. As such, grasping the diversity of the logics present in public-private partnerships is necessary to build suited modes of cooperation. Actors involved in PPP have to construct local arrangements, but have to do so in a global context, which tends to impose specific objects for the running of the collaboration. The management of composite situations requires not only the clarification of the different logic present but an attention to objects and material components that can sometimes look like unimportant details but that, in reality anchor the situation in a specific logic of action, sometimes against the will of the players. The traditional research methods of the pharmaceutical domain, the rules pertaining to intellectual properties or the evaluation criterions of the scientific quality of the research are just some examples of this fact. At this stage, it is already possible to suggest some recommendations to establish compromises. Procedures facilitating the mobility of the scientists from the academia to firms and vice versa, an extension of the practices of patenting or the modification of the expertise nature throughout the construction of hybrid forum are some possibilities that should be explored further. Formalizing the process for the conjoint development of coordination modes through procedures in the PPP seems to lead to better chances of success, as opposed to relying simply on player's initiatives. One must find a balance between directing principals that permit to move away from the conflicting terms at play and to set a frame for the collective decision, and the flexibility that favors contextual negotiation and local agreements. The conflict/disagreements generated within the PPP - and their resolution - can thus be seen as exploration and learning devices, supporting collective activities and giving birth to renewed organizational forms. The management and the valorization of the internal diversity of those partnerships are activities of governance (Lascousme, 2001), all the more important as the interaction between science and market within the pharmaceutical sector generates questions of general interest such as the public health.

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Contact the Author for more References.

End Notes

' a blockbuster is a drug generating more than one billion dollars of annual sales.

"" The pharmaceutical industry, the most likely candidate to commercialize biotechnology products, neither invested in genetics nor had molecular biologists on its research staff. Molecular biology and genetics were almost unknown in industry and, worse still, represented another sort of paradigm with respect to the chemical research large pharmaceutical firms conducted. " (Dalpe, 2003, p175)

"' . Their study is conducted in Canada, but the result should be similar in other countries.

'~ The fitness of the system is the degree to which the system and its context are mutually acceptable (Alexander, 1964, p19)
~ " A learning alliance differs from collaboration to share costs or spred risk across organizations, in that the primary motivation for joining a learning alliance is to gain new knowledge which can be processed and transformed into a competitive asset " (Carayannis et al., 2000,p480)
"' 'The available `windows' for effective public policy intervention at comparatively modest resource costs tend under natural conditions to be located towards the very beginnings of the dynamic process [of innovation]" (David, 1986, p5).
w "Public agencies are likely to be at their most powerful in exercising influence upon the future trajectory [of an innovation] when they know least" (David, 1986, p5).
v"' In the US, the 1980 Bayh-Dole and Stevenson-Wydler Acts can be seen as opportunities for public organizations to use their patents in order to disseminate knowledge rather than to extract rents. We do not mean that it was the first intention of the legislator - one objective was certainly to decrease the amount of direct public funding - but such a " side-effect " must be considered (see also Maurer and Scotchmer (2004) for a slightly different interpretation of the same effect).
"` "The problem, to which Dasgupta and David's (1993) recent analysis draws attention, is whether any single organization can function effectively in managing a truly equal partnership between members recruited from two quite different communities built around fundamentally antithetical sets of norms and cultural orientations and whether it is possible to contain the conflicts that are likely to arise from the disjonctures and lack of congruence between the goals sought by members who have been socialized in, and remain professionally commited to pursuing careers in the different research cultures" (David, P.A., Mowery, D.C. & W.E Steinmuller, " University-Industry Research Collaborations : Managing Missions in Conflict", unpublished paper , March 1994)
" "By conferring monopolies in discoveries, patents necessarily increase prices and restrict use -a cost society pays to motivate invention and disclosure. The tragedy of the anticommons refers to the more complex obstacles that arise when a user needs access to multiple patented input to create a single useful product. Each upstream patent allows its owner to set up another tollbooth on the road to product development, adding to the cost and slowing the pace of downstream biomedical innovation" (Heller & Eisenberg, 1998, p699).
XI’’ A patent gives its owner a right to prevent use of the patented invention by others, but it does not constitute approval for the patent owner to use the invention” (Binns, 2001)

The Challenge of Opportunity:
Small Business and their Websites – Evidence from New Zealand

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Abstract

One of the greatest challenges facing traditional Small and Medium Enterprises (SMEs) throughout the world is that posed by the Internet. In an environment where customers and competitors are moving online, SMEs have little choice but to do the same. However, whilst the Internet offers great potential to SMEs, from improving and cheapening production processes through to reaching global customers, in reality it also poses great problems. SMEs have usually, by definition, limited resources both financial and human. Given the decreasing costs of Information and Communications Technology (ICT) the financial constraints, at least in developed countries, are becoming less of a burden. However, human resource constraints are likely to increase as the technology changes rapidly.

This paper describes a survey conducted amongst small businesses in Wellington, New Zealand, on their use of websites. The research was a joint project between the School of Marketing and International Business at Victoria University of Wellington and the Wellington Regional Chamber of Commerce. The purpose was two-fold. Firstly to find out more about the achievements and challenges encountered by small businesses in the course of their actual business practice. Secondly, to learn what assistance and training they thought would be valuable in order to help them better realise the potential of websites for their business and to face up to and surmount the inevitable problems. It is part of a series of coordinated surveys on this issue, which are in the process of being carried out initially in South Africa and Malaysia.

Introduction

Information and communication technology (ICT) has entered the lexicon of business in many forms throughout the world. It has grown with overwhelming, sometime bewildering rapidity, hype and much confusion (Beal 2003). The rapid development of ICT affects the competitive environment of enterprises throughout the world, though the impact varies considerably by country. However, even in countries where general usage of ICT is low –say Cambodia or Laos, it is still possible for individual companies to participate in the global ICT environment. This means that ICT directly and indirectly affects all sizes of enterprises irrespective of size. Nonetheless, small and medium enterprises (SMEs) face more challenges in using ICT than their larger counterparts This is because they have relatively small and limited resources to understand and utilise the technology, they cannot afford in most cases specialist staff, they do not reap economies of scale and they are vulnerable major mistakes in their operations.

Nevertheless, the prosperity and development of SMEs within this new global ICT environment are becoming more important to the economy of many countries, developing and developed alike. SMEs need to face a number of issues and challenges, but are also presented with more opportunities and prospects by the development of global ICT, which is moving very fast through a number of interlocking modes and forms such as e-commerce, k-economy, website, email, dot.com, etc. An SME may participate in one or several of those forms without the other. Many, for instance, use email but not e-commerce.

The Internet is the main part of the communications aspect of ICT. From 1996, for instance, the number of users of the Internet doubled every nine months, and information flow and bandwidth increased greatly. From a report published by Neilsen/NetRatings recently, there are about 300 million users in just 20 countries (Moha 2003). Although the United States still has the largest number of Internet users (some 165 million) the larger East Asian and European countries now have very substantial numbers of users. The number of users in Pacific Asia, here defined as East and Southeast Asia, Australia, New Zealand and India, already exceeds that in the US, and will continue to outstrip it (CyberAtlas.com).

One important utilisation of ICT is e-commerce. The usage of e-commerce in businesses has also risen over the years. In 1998, for instance, it was recorded that retail income from e-commerce in the United States was US$8 billion and increased to US$18.6 billion in 1999. Based upon the trend, it is expected that the figure would reach something like US$80 billion by the end of 2003. In Europe, income from e-commerce businesses reached US$240 billion in 1999 (Zhonglu 2000).

The rapid increase in general Internet use, as well as the growth of e-commerce, raises the questions, how fast SMEs would and could adjust and adapt to these changes? The question is very relevant to New Zealand, when nearly 97 percent of all private enterprises are small and medium-sized enterprises, contributing for about 44.8 percent of private sector employment (Ministry of Economic Development 2001). New Zealand is predominantly a nation of SMEs. SMEs make a major contribution to job creation. Statistics show that the largest single contributor to job creation was new firms employing less than 5 full time workers, which created 194,000 new jobs between 1995 and 2002. Meanwhile, SMEs account for about 35.1 percent of total national output. SMEs by industrial sectors indicates that SMEs constitute over 98 percent of enterprises in several industries (Ministry of Economic Development 2001).

SMEs facing up to the challenges and opportunities presented by the Internet need to understand as fully as possible the Internet environment in which they operate. While it is known that the Internet as a mass phenomenon and is growing very fast, all enterprises including SMEs enter into businesses and other forms of usage with a rather confusion if not volatile. Internet and other forms of communications is growing steadily fast. The first survey given by Nua (subsequently taken over by CyberAtlas) dates from December 1995 and gave a figure of 16 million people. This consisted only 0.39 percent of the world's population. Some five years later, the number has grown to 407.1 million, representing 6.71 percent of the world's population (Beal 2003). The latest figures reported by CyberAtlas are estimates of 580 million (Nielsen//NetRatings) and 655 million by the International Telecommunications Union. The United States still has world's largest Internet population but now it is only a quarter of the global total. This share will naturally drop as connectivity to the Internet increases elsewhere. Europe and Asia Pacific have most of the rest, leaving the rest of the world, Africa, Middle and Latin America with about 6 percent (Beal 2002). The Asia Pacific countries share of global numbers on line has grown very rapidly. Other than Japan, South Korea is amongst world leaders in terms of ICT use and the percentage of the population with access to the Internet. South Koreans spend twice as much time on the Internet as others (SCMP 2001) and have the highest level of broadband penetration in the world (Korea Herald 2002).

Given the contribution of SMEs to the economy, their use of websites is of great importance and interest. This paper describes a survey on the use of web-site by SMEs in Wellington, New Zealand. It is hoped that the findings of the survey would help small and medium businesses in Wellington, and elsewhere in New Zealand, make better and more profitable use of the web. Since New Zealand is amongst the more advanced Internet countries – it ranks 14 in terms of the percentage of the population using the Internet – it will have more general applicability. The second part discusses the method of the research, while part four reveals some general findings of the survey and briefly discusses what the survey tells us about the training needs of SMEs as they attempt, with their limited respires and expertise, to capture the opportunities presented by websites.

NZ and Mexico in Cyberspace Geography

The use of the Internet varies considerably around the world. It is important there to get some idea of where New Zealand stands in 'cyberspace geography' to ascertain the relevance of this survey to other countries, and in particular, given this conference, to Mexico. We briefly present three sets of data:

1. Connectivity – the percentage of the population with access to the Internet
2. Internet market – the number of people in a country with access to the Internet
3. E-readiness

Connectivity – the percentage of the population with access to the Internet

The data here, and for the next graph, is from the Irish company Nua (subsequently taken over by CyberAtlas), which brought a number of surveys covering most countries in the world. The connectivity rate though, like all Internet data, subject to methodological uncertainties, does give a reasonable sense of the Internet environment. The higher the connectivity rate then the more likely it is that the firm's customers, competitors and supply chain partners, as well as government agencies, information sources etc. will be online and so the greater the pressure of the firm to utilise the Internet.

As Fig 1 shows, New Zealand is amongst the most-wired countries in the world, ranking 14, with just over half the population with access to the Internet. Mexico, on the other hand, comes in at 83, with just 3.4% of the population online.

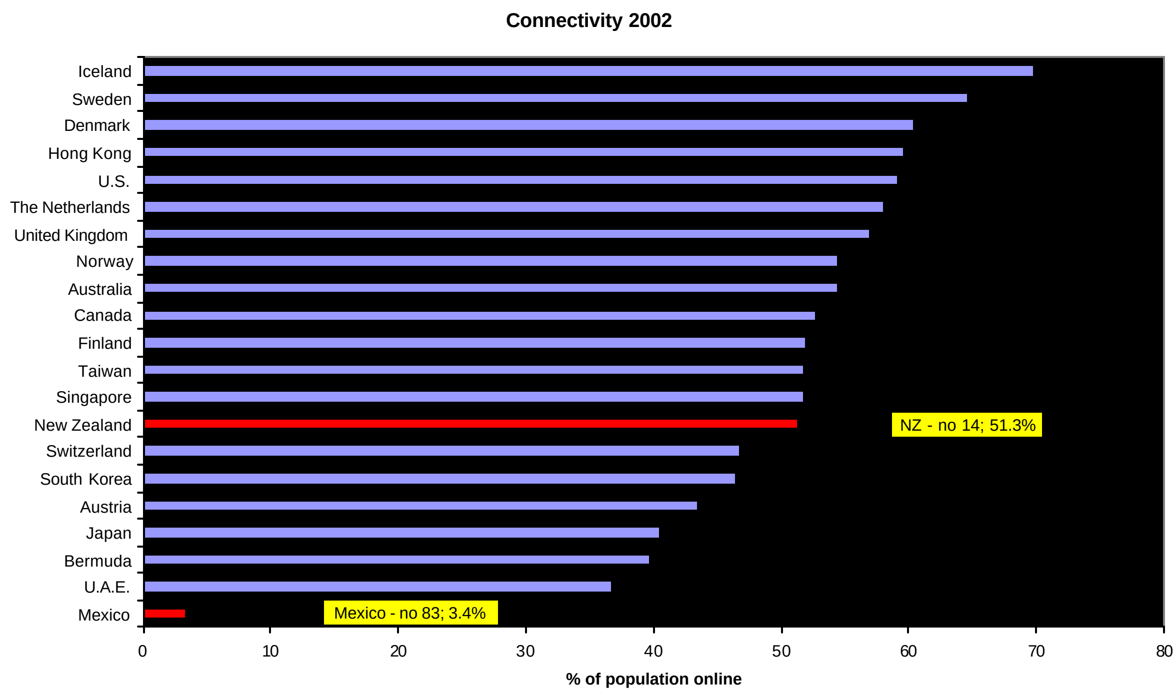

FIG 1: CONNECTIVITY 2002 – TOP 20 COUNTRIES PLUS MEXICO
Source: Calculated from data from Nua, May 2002

Internet market – the number of people in a country with access to the Internet

The size of the market is another motivating factor. In some large countries, with China being the classic example, the connectivity rate may be low but the Internet market still significant. As Fig 2 indicates, Mexico's Internet market is nearly twice the size of that of New Zealand. Moreover, the proximity to the huge United States online population (166 million) and specifically the Hispanic part of that, offers great incentives for Mexican firms to go online. It should be remembered that whilst the Internet itself is distance-neutral, most firms are dealing in physical goods and services so the old constraints still apply, and proximity to market is a valuable asset.

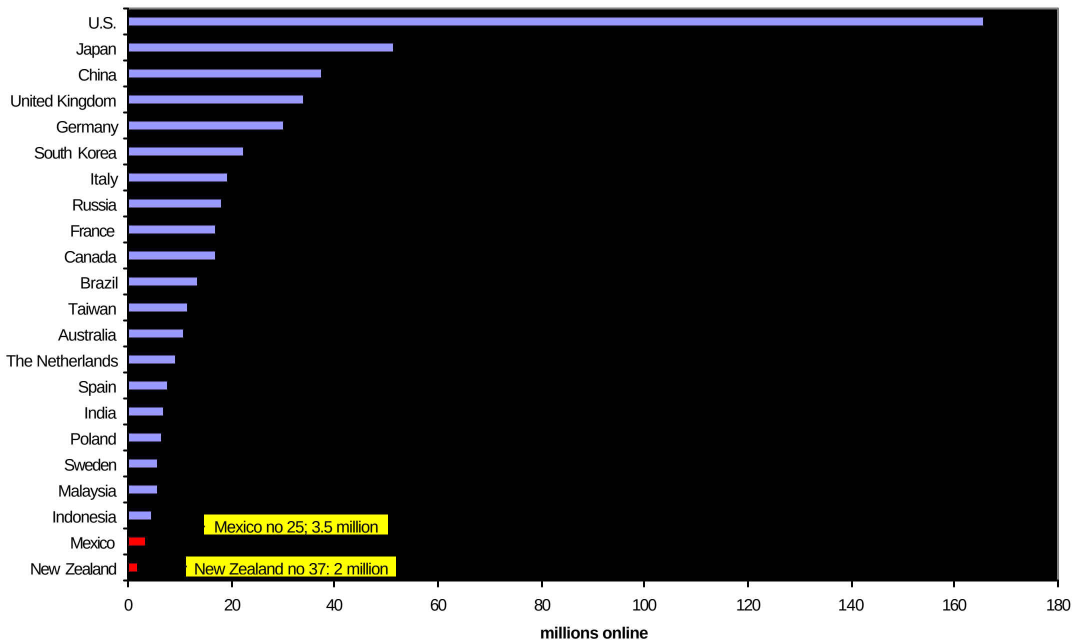

FIG 2 SIZE OF INTERNET MARKET, 2002
Source: Calculated from data from Nua, May 2002

E-readiness

A number of companies attempt to assess 'E-readiness', which may roughly be translated as the conduciveness of the national environment to use business use of the Internet. The survey used here is from the Economist Intelligence Unit and was conducted in March 2003. New Zealand comes out considerably better that Mexico, indicated that the barrier for New Zealand firms to use the Internet is lower than for their Mexican counterparts, and the Internet environment is generally more supportive.

Relevance of the Wellington survey

It is clear that for these and other reasons the business environment in which Wellington firms operate, and in which they decide upon and implement and Internet strategy, differs in many ways from that obtaining in Mexico, or elsewhere. On the other hand there is not reason to suppose that these differences are so marked that they make the experience of Wellington firms atypical. The differences should be borne in mind, and the particularities of the New Zealand situation noted, but it seems fair to say that the results of this survey have a general relevance beyond the confines of Wellington itself. How relevant they are for, say, Mexican firms, is perhaps something best left to Mexicans to judge.

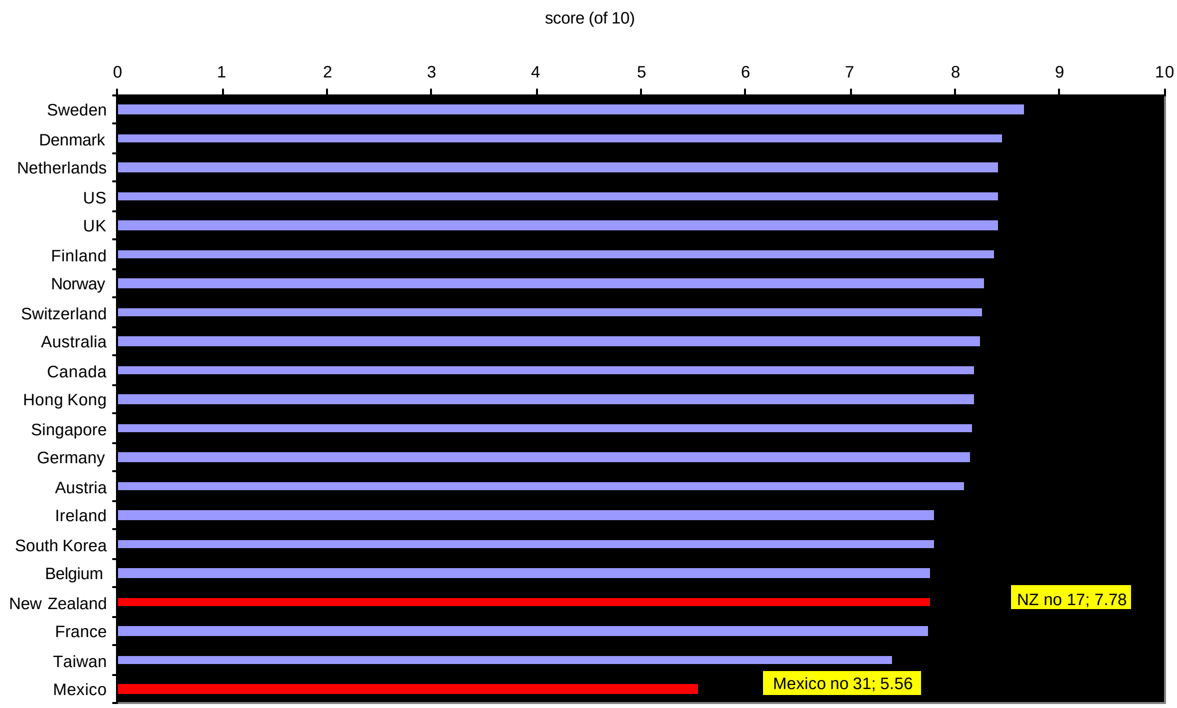

FIG 3 E-READINESS 2003

Source: Economic Intelligence Unit, downloaded 17 August 2003

The research method

It is widely acknowledged that definitions of small and medium enterprises differ across countries and sectors. However, observation shows that there is a common pool of criteria, which is normally used in defining it. This includes number of full time employees, invested capital, personal ownership and management and total value sales or turnover or profit before tax. In many countries only one or a few of the above characteristics are typically chosen depending on the purpose of the study. In New Zealand SMEs are usually defined as enterprises employing 19 or fewer full time equivalent employees. Within SMEs, small enterprises are defined as those employing not more than 5 full time equivalent emp loyees and medium enterprises as those employing 6-19 full-time equivalent employees.

The study focuses on website use by members of Wellington Regional Chamber of Commerce (WRCC) whose email address was registered with the Chamber. The survey was carried out as a joint project with the School of Marketing and International Business of Victoria University of Wellington. The study did not formally confine itself to SMEs, because WRCC does not categorise its members it this way. However, the membership is predominately SME so the survey can be said to be SME-focused. The survey was carried out between late February and early March 2003. An email was sent to members who were requested to link to a secure website on which the questionnaire was posted. It should be stressed that all the members surveyed were thus, by definition, connected to the Internet. We cannot say how typical they are of SMEs in general. Out of 842 Chamber members surveyed, a total of 106 SMEs returned the questionnaire with a completed answers. The data was processed and analysed in the SPSS and some basic statistics were used in order to substantiate the findings.

General Findings

Out of 106 SMEs surveyed, over 40 percent or 43 enterprises have the turnover of less than $NZ500,000. Nonetheless, a significant percentage of the total sample, i.e. 32.1 percent has the turnover between $NZ10 and $NZ50 million, while another 4.7 percent with turnover more than NZ$50 million (see Table 1). The findings reflect that the size of SMEs in New Zealand is quite varied in nature, small and as well as medium sizes.

SMEs in the survey are currently quite inward looking as far as customer base is concerned. The findings show that about 28.3 percent of them market the products in the area of Wellington only, besides another 42.5 percent market the products nationally. Table 2 shows that those SMEs in the survey that market the products globally is only 20.8 percent, while another 8.5 percent restricted their markets to New Zealand and Australia only. To some extent this local focus reflects the nature of their business.

TABLE 1: TURNOVER OF THE ENTERPRISE ($NZ)

Turnover	Frequency	Percent
Less than 100,000	19	17.9
100,000 – 499,999	24	22.6
500,000 – 999,999	15	14.2
1 million – 9,999 million	34	32.1
10 million – 49,9999 million	9	8.5
50 million and above	5	4.7
TOTAL	106	100.0

TABLE 2: SMES BY THEIR CURRENT CUSTOMER BASE

Market Level	Frequency	Percent
Wellington only	30	28.3
National (New Zealand)	45	42.5
New Zealand & Australia only	9	8.5
Global	22	20.7
TOTAL	106	100.0

The findings of the use of computer in SMEs are revealed in Table 3. It shows that about 16.0 percent of the sample has more than 50 computers. Moreover, 37.7 percent of them used between one and five computers, while another 16.9 percent and 16.0 percent respectively used from six to ten and from 11 to 20 computers. Curiously one of the surveyed SMEs claimed not use a computer at all for business, but since the survey was conducted by email this is difficult to interpret. Based upon the findings, it seems that once Wellington SMEs move into ICT they do it with some gusto.

TABLE 3: SMES BY THE NUMBER OF COMPUTER USED

Number of computer used	Frequency	Percent
Nil	1	0.9
1-5	40	37.7
6-10	18	17.0
11-20	17	16.0
21-50	13	12.3
50 and above	17	16.0
TOTAL	106	100.0

The findings show that a total of 67.0 percent or 71 respondents have websites as compared to 33.0 percent of them that do not have any website. This suggests that a majority of SMEs in New Zealand who have Internet access currently have a website as a way of doing, operating and managing their businesses to some extent. It should be recognised that the sample is likely to be more enthusiastic about ICT than the norm. The very fact that they have answered an email survey on the subject reflects that.

Table 4 confirms, as expected, that the website established by the enterprises is relatively new with more than 80 percent have set up the website less than 5 year ago. Out of this, about 57.7 percent has set up the website between 2 and four years ago. Besides, only 4.2 percent has set up the website between eight and ten years ago, being the smallest percentage. The newness in setting up the website is very much correlated to the recent and rapid development of ICT industry in the country and global development.

TABLE 4: SMES BY STATUS OF WEBSITE AND ESTABLISHMENT OF WEBSITE

Status of Website	**Frequency**	**Percent**
SMEs with website	71	67.0
SMEs without website	35	33.0
TOTAL	106	100.0
Year of Setting up Website	**Frequency**	**Percent**
Less than 2 years ago	18	25.4
2 to 4 years ago	41	57.7
5 to 7 years ago	9	12.7
8 to 10 years ago	3	4.2
TOTAL	**71**	**100.0**

The principle aim of setting up a website should be to improve the business in some way. Table 5 shows that those who had established websites were broadly satisfied. 26.8 percent claimed that the setting up of the website had produced high and better performance for them, while another 46.5 percent said they had been moderately successful. Only 26.8 percent said that website had either not made much difference, or it was too early to judge the level of success. Thus, three quarters of the respondents who had websites found them worthwhile.

The findings are highly correlated to the objectives of the website perceived by SMEs in the survey. As illustrated in Table 6, the main objectives stated by SMEs in setting up the website, among others include; to enhance corporate image; to reach new market in New Zealand; to enable customer to check products; to communicate better with existing customer; to reach new market overseas; to compete with large companies and besides some other reasons.

TABLE 5: LEVEL OF SUCCESS WITH WEBSITE

Level of Success with Website	**Frequency**	**Percent**
Very successful	19	26.8
Moderately successful	33	46.5
Has not made much difference/Too early to measure	19	26.8
TOTAL	**71**	**100.0**

TABLE 6: THE OBJECTIVES OF SETTING UP WEBSITE

Objective of the Setting up Website	**Yes**	**Percent**
To enhance corporate image	56	78.87
To reach new markets in New Zealand	42	59.15
To Enable customer to check products	42	59.15
To communicate better with existing customer	41	57.75
To reach new markets overseas	31	43.66
To compete with larger companies	30	42.25
To grasp technology in business	28	39.44
To catch up with competitor	25	35.21
To enable to open all the time	23	32.39
To provide access to manuals, detailed product information etc	21	29.58
To replace the stocking or mailing of paper-based information	18	25.35
To provide means of customer to staff communication	16	22.54
To enable customer to order product	13	18.31
To provide saleable/subscriptions electronic material	11	15.49
To enable customer to pay for products	8	11.27
To provide an information resource for scattered staff	8	11.27

Note: The number and percentage of answers exceeded the total due to a respondent was allowed to select more than one answer.

As expected, the companies encountered a number of problems. Table 7 reveals that 22.5 percent of them acknowledge website took too much internal resource to maintain, another 21.1 percent said their staff who not have the required expertise, while another 18.1 percent revealed that the website generated no extra business to them. This last problem is not strictly incompatible with the most favourite objective of establishing a website, namely to improve corporate image. Whilst a better corporate image is intuitively presumed to be at least conducive to generating business it might not necessarily follow. In addition, a company might be happy with a better corporate image even though that had no discernable impact on business purely for reasons of self-esteem.

TABLE 7: PROBLEMS ENCOUNTERED BY SMES WITH WEBSITE

Problems encountered	Yes	Percent
Took too much internal resource to maintain	16	22.54
Staff did not have the required expertise	15	21.13
No extra business was generated	13	18.31
Took staff from more profitable duties	12	16.90
ISP performance was unsatisfactory	9	12.68
Set-up costs were too high	8	11.27
Consultants did not understand our business	7	9.86
It was difficult to find qualified and dependable consultants	7	9.86
Maintenance costs were too high	6	8.45
It created customer demands/expectations we couldn't cope with	4	5.63
Internet service provider (ISP) cost was excessive	4	5.63
There were security problems	1	1.41
Other	10	14.08

Note: The number and percentage of answer exceeded the total since a respondent was allowed to select more than one answer.

Further analysis is performed through SPSS to find out the level of relationship between a few main variables and the SMEs' status of website. The three main variables are analysed, i.e. number of computers that SMEs use, current customer base and turnover of SMEs. Those three variables are individually tested using normal cross tabulation (or cross tab) and then Chi-Square Test as well as Fisher's Exact Test, whichever is appropriate. The findings reveal very interesting and indicative results. Table 8 points out the relationship between the number of computers that SMEs use and whether or not they have a website. It clearly shows that the higher the number of computers in use, the more likely the company is to have a website. Fisher test result indicates that the relationship is very significant with probability of $P<0.008$. This means that SMEs with website tend to use more computers in their business operation.

TABLE 8: STATUS OF HAVING WEBSITE BY NUMBER OF COMPUTER USED BY SMES

Number of Computer Used	**Status of**	**Website**	**TOTAL**
	SMEs with Website	SMEs without Website	
None	1 (100)	-	1(9.4)
1-5	18 (45.0)	22(55.0)	40(37.7)
6-10	13 (72.2)	5(27.8)	18(17.0)
11-20	13(76.5)	4(23.5)	17(16.0)
21-50	11(84.6)	2(15.4)	13(12.3)
50 and above	15(88.2)	2(11.8)	17(16.0)
TOTAL	71 (67.0)	35 (33.0)	100.0

Note: Figure in bracket is percentage
Fisher Test = Value, 14.576; Exact Sig. .008; $P < 0.01$

The second relationship, i.e. between current customer base and the status of web site in SMEs is illustrated in Table 9. The finding is quite clear that SMEs with website tends to have broader customer base, while SMEs without website tends to concentrate their market around Wellington region and New Zealand only. The relationship is strong with the value of Chi-Square Test is 9.883 and exact significant level of 0.018.

TABLE 9: STATUS OF HAVING WEBSITE BY CURRENT CUSTOMER BASE OF SMES

Status of Customer Base	**Status of**	**Website**	**TOTAL**
	SMEs with Website	SMEs without Website	
Wellington Region only	14(46.7)	16(53.3)	20(18.9)
New Zealand only	31(68.9)	14(31.1)	33(31.1)
New Zealand and Australia only	7(77.8)	2(22.2)	17(16.0)
International	19(86.4)	3(13.6)	36(34.0)
TOTAL	71(67.0)	35 (33.0)	106(100.0)

Note: Figure in bracket is percentage
Chi-Square Test = Value, 9.883; df 3, Exact Sig. .018; $P < 0.05$

Table 10 shows a quite similar result, that is SMEs with website tend to have higher value of turnover. The result is validated by the Fisher's test, which indicates that the relationship is strong at the value result of 11.166 and exact Significant level of 0.039. This is consistent with the distance-neutrality of the web.

TABLE 10: STATUS OF HAVING WEBSITE BY SMES' TURNOVER

Turnover of SMEs (NZ$)	**Status of Website**		**TOTAL**
	SMEs with Website	SMEs without Website	
Less than 100,000	8(42.1)	11(57.8)	19(17.9)
100,000-499,999	14(58.3)	10(41.7)	24(22.6)
500,000-999,999	13(86.7)	2(13.3)	15(14.2)
1 million-9.999 million	25(73.5)	9(26.5)	34(32.1)
10 million-99,999 million	6(66.7)	3(33.3)	9(8.5)
10 million and above	5(100.0)	-	5(4.7)
TOTAL	71 (67.0)	35 (33.0)	106 (100.0)

Note: Figure in bracket is percentage
Fisher Test = Value, 11.166; Exact Sig. .039; $P < 0.05$

Training and Support Needs

Of great importance to the WRCC, and of particular relevance to this conference, was the final set of questions on training and support needs

The rubric read:

Whether you have a website or not, you want to make the best possible decision for your company. And if you have a website the decisions don't stop there. Are you getting value for money? Are you realising the potential of the technology? Could you be doing things better? Here are some possible ways the Chamber of Commerce could assist you in the web area. Please tick the ones you would find useful.

There were then two questions, each with a set of options and an opportunity to give an open-ended answer.

It should be remembered that these questions relate to service which members felt the WRCC might provide, so they do not necessarily reflect needs in general, that might be satisfied in other ways. In other words, respondent might perceive a pressing need for 'Accreditation of reputable commercial website developers' but not regard the WRCC as a suitable provider. However, since none of the respondents made this point in the open-ended section it seems likely that these answers do represent their perceptions about needs in general.

TABLE 11: WEB-BASED SERVICES

	no	%
Third party website verification service	40	37.7
Online business advice	48	45.3
Publications	48	45.3
Online booking/registration for WRCC events	53	50.0
Business information and statistics (e.g. web use data)	57	53.8
Directory of members and services	62	58.5
Accreditation of reputable commercial website developers	35	33.0

Curiously the only suggested service bearing directly on building a website, 'Accreditation of reputable commercial website developers' gets the lowest score. This may mean that most respondent were happy with designers, or their ability to chose the right one. On the other hand those who had already established a website might have felt this was now past history.

As is often the case, the open-ended answers gave hints that some companies at least found designers and IT specialists

- ?? Aligning web needs with developers, i.e. ensuring that low tech needs are matched with low tech providers and high need with high tech providers. Not every web site needs all bells and whistles and full suite of latest high tech ad-ons. A presence may suffice in many cases with add-ons coming later if needed.
- ?? A source to ask the simple (dumb) questions about computer use in general. presently this is done by phoning a friend who knows a bit about computers. Help pages always seem very complicated to navigate to and all I want to do is talk to someone and explain my problem. When I eventually get that opportunity often the solution is given very quickly.
- ?? Advice tailored to small corporate business services companies such as ours.

This is clearly an area that needs exploring further. It is hoped to use the results of this survey as a foundation for in-depth interviews.

The other question related to staff development.

TABLE 12: STAFF DEVELOPMENT (NOT NECESSARILY WEB-BASED):

General seminars on web marketing	52	49.1
User forum to network with other companies	27	25.5
Short training courses for non-specialists	56	52.8
In-depth courses - e.g. for particular web software	16	15.1

The results clearly indicate that the respondents felt the need for general, non-specialist training. This is consistent with what we know about SMEs in general; they are generally run by people who have to cope with a the whole gamut of business functions who need to interact with specialists such as accountants, lawyers and IT people, but do not have the time to develop specialist expertise in these areas themselves. It is noteworthy that the option with by far the lowest score (15%) was for specialist courses and the one with the highest (53%) was for non-specialist courses. General seminars on web marketing came a close second.

However, it is evident that although the scores varied, there was a high demand for all these suggested services. The respondents clearly felt there was a need for the WRCC to provide training and help for its members and they were conscious that their own utilisation of the web could be improved. In other words, they saw the web as a tool which they could use better to develop their business, but they did not want to be side-tracked into spending too much time and energy on the technology, and the mastering of it.

As one respondent put it:

Web marketing has to be understood in the wider marketing context. The web is not the only tool. In fact it is often over valued in marketing and has been since the beginning. Advice should be to look at marketing needs and methods including the web.

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On the Business Model of a Biotechnology Venture in a Biotechnology Cluster of Sweden: The Case of Stockholm-Uppsala Area

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Abstract?

As main purpose of here, by dealing with Sweden where the basic research level of life science is traditionally high as compared with the GNP or population, there are also some biotechnology clusters, some biotechnology ventures divide the work for each drug development stage with restructuring progress of the big pharmaceuticals firms, and both numbers of biotechnology venture and IPO biotechnology venture are relatively many, this article will examine the network of anti-entropy as a division-of-work network where the progressive biotechnology venture can be created. More specifically the article will, at first, discuss the network characteristics with the accumulation and feature of biotechnology ventures in main biotechnology clusters. Next, it will examine the possibility of the drug development by the ventures from the viewpoint of the autonomous division of work within pharmaceutical industry. And thirdly, it will investigate the drug development process and business model of a biotechnology venture which attained IPO.

Introduction

As a research background, some biotechnology ventures that are successful considering the scale, in spite of resources-restrictions of financial or human resources, with the high productivity of development based on innovative ideas exist. For example, according to Robbins-Roth (2000), as compared with Merck & Co of a large-scale pharmaceutical firm, the top 100 biotechnology ventures containing Genentech, Amgen, and Millennium excel in the productivity of per resources and of development for drug candidates.

However, as research questions, firstly, is it enough for the entrepreneur of a biotechnology venture to commercialize the original and creative ideas, with just the isolated and gifted talent? Secondly, why is the product development possible for biotechnology ventures with very few black-figures firms or being no product incomes for a long period of time, even if they succeed in IPO, while a high-risk project like drug development is characterized by a long-term equilibrium between supply and demand? And thirdly, how is it necessary to make evolve a business model, if the participation to drug development is possible also for biotechnology ventures, with progress of a drug development process?

A framework here is based on the network relevant to the business model of anti-entropy. That is, this framework will examine the autonomous mechanism which makes to occur and evolve the innovative idea produced by chance for business of high productivity, at three levels as a biotechnology cluster, a drug development value chain, and a business model of a biotechnology venture. And there are mainly two kinds of types of biotechnology ventures as the start-up from a university and the spin-off from a large firm. First, a university, VC, a technology transfer unit, and a large firm are contained, as the composition elements generating biotechnology ventures, in the biotechnology cluster as its accumulation. Next, there are the drug development stages and the drug developmental tool and service common to the each stage, within the drug development value chain as a division-of-work map in the middle between a university and a large pharmaceutical firm. And third, the evolutional mechanism of business model is required to enrich the development technology and the cash flow for promoting development further with progress of a drug development process, for a biotechnology venture. As main purpose of here, by dealing with Sweden where the basic research level of life science is traditionally high as compared with the GNP or population, there are also some biotechnology clusters, some biotechnology ventures divide the work for each drug development stage with restructuring progress of the big pharmaceuticals firms, and both numbers of biotechnology venture and IPO biotechnology venture are relatively many, this article will examine the network of anti-entropy as a division-of-work network where the progressive biotechnology venture can be created. More specifically the article will, at first, discuss the network characteristics with the accumulation and feature of biotechnology ventures in main biotechnology clusters. Next, it will examine the possibility of the drug development by the ventures from the viewpoint of the autonomous division of work within pharmaceutical industry. And thirdly, it will investigate the drug development process and business model of a biotechnology venture which attained IPO.

1. The Biotechnology Cluster

As the reasons that the country should attract attention in biotechnology industry, it is supposed, about the biotechnology cluster, that the number of biotechnology ventures is a top level also in Europe, there is a capability to analyze the relation between heredity and environment, the relation among the industry, the university, and the public medical institution is close, and there are VC funds and the capital market specialized in biotechnology (Invest in Sweden Agency, 2002).

1-1. The Number of Swedish Biotechnology Firms

In 2000, the number of biotechnology ventures of Sweden is the 4th place in Europe at 235 companies, subsequently to 504 companies of Germany, 448 companies of UK, and 342 companies of France. However, more than 100 companies were founded between 1996 and 2001 in Sweden, and its relative number size is the 1st place in Europe to the population and GDP (ISA, 2002). By the way, the number of the U.S. biotechnology ventures in 2000 is 1,273 companies (Ernst &Young, 2000), and that is about 300 companies in Japan in 2002 (JBA, 2003).

As the reasons of relatively many biotechnology companies of Sweden, the long history of the basic and clinical research of biotechnology, the cooperative industry-university atmosphere, the restructuring of the major pharmaceutical companies, and the present foundation boom are mentioned. According to Vinnova (Swedish Agency for Innovation), 93% of biotechnology ventures carries out the cooperative research with universities, and many biotechnology ventures are based on the research result in universities. Moreover, blockbuster drugs, such as Xylocain, Seloken, Losec, Prilosec, and Genotropin were developed by industry-university co-operation in the past. Furthermore, even in the pioneering medical device domain, a transplant pacemaker, an artificial kidney, a laser surgical unit, a titanium implant, a blood plasma substitute based on a polysaccharide, a separation method, a super-centrifuge, and an electrophoresis method are developed in this country.

Furthermore, many employees of biotechnology ventures are the skillful persons who changed their jobs into the ventures under the influences of the restructuring by former Pharmacia and AstraZeneca.

1-2. The Company Distribution of the Biotechnology Clusters around Universities and Big Firms

The representative features of the biotechnology clusters of Sweden include the proximity to universities and university hospitals, the support by VC, and the capability of founders who transform scientific discoveries into businesses. The biotechnology venture accumulation in the country mainly consists of three major clusters as Stockholm-Uppsala, Göteborg, and Malmö-Lund, and of two peripheral clusters as Linköping and Umeå.

Table 1: COMPANY COMPOSITION OF SWEDEN BIOTECHNOLOGY CLUSTERS IN 2001

REGION	RATIO
Stockholm-Uppsala	54%
Malmö-Lund	15%
Göteborg	14%
Umeö	2%
Other	15%

Source: Invest in Sweden Agency, Biotechnology, 2002.

1-2-1. Stockholm-Uppsala Area.

Capital Stockholm and a university town Uppsala are domestic core areas, and occupy the share of more than half of domestic biotechnology companies, with many resources of life science. Especially, the academic research tradition and the presence of big pharmaceutical firms like Pfizer (firmer Pharmacia) and AstraZeneca at both cities are the bases of biotechnology industrial formation of this area. First, five of eight domestic Nobel-prize winners in medicine and physiology area are KI (Karolinska Institute) related persons. KI covers about 40% of medical research in domestic universities including the medical institutes of Karolinska Hospital and Huddinge University

Hospital, and is the global research institute of medical science. And, Department of Biotechnology at Royal Institute of Technology is also one of the main fountainheads of entrepreneurial activities. The business foundation activities like spin-off or start-up are active at Uppsala where the head office of former Pharmacia was located. More than 100 biotechnology ventures have been founded here. As the reasons, the compactness of a town, the research resources including Uppsala University, the ease access to VC, and the availability of the skilled people from the restructuring of former Pharmacia are considerable. While many biotechnology companies of Uppsala are specializing in a remarkable degree in the tool and service business (examples: Biacore, Gyros, and Pyrosequencing), those of Stockholm are concentrating on the drug development value chain (examples: Affybody, Karo Bio, and Medivir). Industry-university interaction is supported by Karolinska Innovation AB as a technology-transfer company, Karolinska Investment Fund as an investment fund of a joint venture between the university and an insurance company, and Novum Science Park.

1-2-2. Göteborg Area.

Sahlgrenska Academy at Göteborg University is the medical research institute produced some Nobel-prize winners, and contributed to development of blockbuster drugs like Losec/Prolosec. As companies in the city, the research base for cardiovascular/gastrointestinal of AstraZeneca is located, and there are Arexis, Angiogenetics, Carlsson Reseaqrch, Cell Therpeutics Scandinavia, and Vitrolife as the biotechnology ventures of the drug discovery and development. For commercialization of technology, there are A-Plus Science Invest as a technology licensing company, Chalmers Innovation as an investment fund, and Sahlgrenska Science Park.

1-2-3. Malmo-Lund Area.

This biotechnology accumulation region including an adjoining Denmark-Copenhagen area is called Medicon Valley, and has the universities, about 100 biotechnology companies, science parks, and core facilities. Infrastructure development is made around Lund University or Ideon Science Park in this area of Sweden. Active Biotech, Biounvent, Biora, and Clinical Data Care are included in a bio-medical related industry.

1-3. Venture Capital

The number of Swedish VC companies increased from about 25 companies to 200 or more companies during 1995 to 2001. The amount of funds which could be used for VC also increased to 10 times as many SEK 2000 billion (Euro 22 billion) as in this period. Even in the amount of funds of VC industry, about half of investment by the member of Swedish Venture Capital Association was made to the domain of biotechnology, medical treatment, medical technology, and pharmaceuticals in the 3rd quarter in 2001. And 20% or more of capital is distributed to the early stages as seed or start-up phase. As the representative examples of VC companies which specialized in life science, the sophisticated investors such as HealthCap, Investor Growth Capital, Nordic Capital, and Karolinska Investment Fund attract attentions. International syndicate investments were also made. For example, 2nd round financing of SEK 309 million to Gyros by 3i, Investor Growth Capital, Karolinska Investment Fund and HealthCap in December, 2001, has attained the maximum scale of biotechnology VC financing in the country. Also with IPO, 16 biotechnology ventures, including Active Biotech, Karo Bio, Medivir, and Perbio Science achieved at going public to Stockholm Stock Exchange.

1-4. Technology-transfer Company

As the innovation of pharmaceutical industry inclines in biotechnology, the tendency to think the basic research in universities as important is arising. The technology licensing organizations and investment funds in universities are supporting the early stage of business foundation. First, as "teachers exemption", in case own invention is commercialized, unless the discovery has an exceptional relation with a university, the right which commercializes all is protected for the university researchers of the country. Moreover, while the technology licensing organizations (companies) are established in many universities of the country in order to pull out economical value from the research results of universities, in many cases, they are managed as the holding companies which maintain the rights to start ventures. As the technology-transfer companies, Karolinska Innovation AB in Stockholm, A-Plus Science in Göteborg, and Teknopol in Lund can be mentioned as representative examples. Those functions are to carry out also strategic and expertise advice about venture foundation and operation in addition to patent filing and licensing. And as a campus investment fund, for example, Karolinsk Investment Fund is established by KI and a Sweden insurance company Alecta in 1999, and is mainly carrying out the portfolio investment to 11 companies in the special domain of the medical science, biotechnology, and medical technology by the early 2002. Furthermore, a networking organization like Connect Sweden which is expected to introduce technical, financial, and business developmental resources to entrepreneurs also exists. Although an original and creative idea is emphasized not only with biotechnology but also with a venture, the fact that biotechnology ventures crowd and are unevenly distributed in specific areas as a biotechnology clusters is considered to be the proof which entrepreneurs tend to access to the specific location of or is building the original network on which information is crowdedly flowing, rather than that entrepreneurs are isolated and investigate original ideas.

2. The Medicine Development Value Chain

As one reason the biotechnology industry of Sweden attracts attention, the complement-division of work in drug development process by ventures is possible, because there are substantial ventures for all stages of the new drug development value chain and for the drug development support service as a clinical test service.

2-1. Genomic Drug Discovery

The main drivers of economical transformation of the R&D system of pharmaceuticals industry are the technological innovation of genomic analysis and its introduction to drug development. Thus, many ventures which specialize in each niches, such as drug discovery, biotechnology tool, and a clinical test, have come to cover the very drug development process by division of work against the large-scale pharmaceutical companies which had conventionally performed the whole drug development stages for themselves. Furthermore, some ventures exceed big firms by advanced development as functional genomics.

2-2. Full Value Chain Reorganization

2-2-1. Spin-off and M&A of Big Business.

The restructuring of big pharmaceutical firms and the increase in venture foundation in Sweden are reflecting the global trend which asks for the efficiency improvement of the drug development value chain. As former Pharmacia and former Astra which were the Swedish domestic companies changed themselves into the U.S. company Pfizer and the British company AstraZeneca, many large pharmaceutical firms have repeated M&A and its related restructuring, for the purpose of R&D budget procurement and the inclination for later stage of drug development. Consequently, many of skillful researchers of large pharmaceutical firms left for founding new ventures or becoming employees at ventures. Especially at Uppsala where the head office of former Pharmacia was located, many ventures started their businesses by utilizing unused resources, such as scientific people and VC. Such network-reorganization of drug development process meets the trend for the improvement in productivity as a whole.

2-2-2. Venture Niche Market.

With the improvement in prediction by genomics of the disease possibility and drug reaction, there are some ventures which are aiming at the identification of the disease targets and the drug candidates, and at the creation of new technologies, and also some more ambition-ventures which actually carry out to the conceptual proof of drug candidates are going to license out to the large-scale pharmaceutical firms responsible to later stage of drug development. For example, Karo Bio doing the drug target research in the core receptors, Melacure Therapeutics doing the drug discovery of the melanocortin receptor targets, and Medivir studying the medical treatment compounds in the infection and autoimmune diseases are included in this aggressive category.

And in genomics and proteomics research, there are attention attractive ventures as Aredxis, AngioGenetics, and Affibody which aim at the improvement in productivity of drug discovery by integration with high throughput technology and computer technology, and another ventures as Prevas Bioinformatics, Global Genomics, and Spotfire which correspond to the huge information produced by bioinformatcis as the fusion of biology and computer analysis. Moreover, in the domain of drug development support, there are Canag Diagnostics, IDL, Cellavision as the diagnostic drug ventures which contribute to the drug development by progress of the monoclonal antibody, Amersham Biosciences, Biacore, and Pyrosequencing as the development support tool ventures (bio med-tech suppliers), and Medical Products Agency, Scandinavian CRI, and Berzelius Clinical Research Center as the clinical research support ventures. The biotechnology ventures cover each special niche market through the whole value chain of drug development of the country. On the other hand, the drug development support systems, such as the schemes stimulating the industry-university cooperation, the foundations supporting the large-scale functional genomics research, the bio-banks, and the diseases management system are also established.

Table-2: SWEDEN BIOTECHNOLOGY RESEARCH TALENT'S DISTRIBUTION WITHIN VALUE CHAIN

Drug Development Stage	Ratio
Target Identification	29%
Target Proof	8%
Chemical Screening	16%
Chemical Optimization	8%
Pre-clinical Development	3%
Clinical Development	36%

Source: Boston Consulting Group, Sweden Brain Power, 2001.

Table-3: EXAMPLE OF BIOTECHNOLOGY VENTURE IN DRUG DEVELOPMENT VALUE CHAIN

Drug Development Stage	Company
Target Identification	Affibody, Biacore, Biovitrum, Carlsson Research, Global Genomics, Karo Bio, Pyrosequencing
Target Proof	Active Biotech, Esperion, Medivir, Melacure Therapeutics, Neuronova, Resistentia Pharmaceuticals
Pre-clinical Development	Amersham Biosciences, Bacterum, Bioinvent, Biophausia, Camurus, Diamyd Medical, Q-Med,
Clinical Development	Abigo Medical, Berzelius Clinical Research Center, Biora, Clinical Data Care, Conpharm, Elekta, Glycorex,

Source: Invest in Sweden Agency, op cit

2-3. Feature of Uppsala as a Biotechnology Tool Development Division-of-work Cluster

Stockholm and Uppsala are located across Arlanda Airport within a commuter region. While the biotechnology ventures of Stockholm concentrate on the drug development, those of Uppsala are specializing in development of the tool for drug development.

2-3-1. The Mechanism of Development Division-of-work Formation. In the domain of biochemistry, Sweden including Uppsala with Uppsala University of 500 years tradition has developed world's first technologies, such as the 1920s ultra centrifuge by Svedberg, the 1940s electrophoresis by Tiselius, and the 1960s chromatography for protein purification by former Pharmacia. As an example of a gatekeeper for the technology-transfer network from a university, Mathias Uhlén, Professor of Royal Institute of Technology and a member of National Research Council, applies for many patents in proteomics, supports many biotechnology venture foundations in Uppsala-Stockholm area, and has involved with many boards of directors and science adviser boards. In addition, about since the 1990s when global M&A of large pharmaceutical firms began to increase, in the biotechnology tool domain, about 135 companies as Biacore, Pyrosequencing, and Gyros have been founded around former Pharmacia and formed division of work of a biotechnology tool development in Uppsala rather than drug development.

As the formation factors of Uppsala as a tool development division-of-work cluster, first, the tradition of biochemistry exists in Uppsala. Next, pharmaceuticals industry is asking for the tool required for development of molecule medicine. And a large amount of risk capital is invested in the ventures of Uppsala from VC. Furthermore, the surplus of the human resources accompanying the restructuring by large pharmaceutical firms and of buildings from an army move exists, and R&D staff's labor cost is also estimated as about half of U.S..

2-3-2. Spin-off.

In Uppsala, former Pharmacia (the present Pfizer) after Pharmacia & Upjohn changed into specializing in the latter stage of drug development, unified Amersham Life Sciece which is the life science business of Amersham after Nycomed Amersham and Pharmacia Biotech, and made Amersham Pharmacia Biotech (the present Amersham Bioscieces). And former Pharmacia made also a drug development section of Stockholm spin-off as Biobitrum.

2-3-2-1. **Amersham Bioscieces**.

The Uppsala business unit of the comp any has been the core-existence of the Uppsala biotechnology cluster which has developed in the past ten years, and its sales are growing rapidly with the recent rise of the importance of protein research. Although former Pharmacia Biotech had a track record of the product development for separation/purification of the protein since the 1960s, Amersham Pharmacia Biotech (Amersham Bioscieces) was made by integration in 1997 of Amersham Life Sciences, a section of Britain Amersham, and Pharmacia Biotech, a section of Pharmacia. In the support tool offer strategy to all the drug development processes by the British head office, the chemical separation business unit of Uppsala is based on the former expertise of development and manufacturing of the product for protein purification/separation. Especially, since the focus of medicine research is concentrating on protein further with advance of the genome map, this business unit aims at supply of the advanced system which makes the protein analysis more quick and efficient.

2-3-2-2. Biacore.

In 1984, this company had been founded as Pharmacia Biosensor AB, by investment of SEK 550 million for initial development of a product system and of basic technology, and by integration of know-how and technical knowledge from former Pharmacia, Linköping Institute of Technology, and Swedish National Defense Research Institute. And in 1996, the company name was changed into Biacore AB before M&A of Pharmacia, and its independency was strengthened on the basis of Pharmacia's support. As of June, 2002, it had the employee number 316, the yearly turnover SEK 543.7 million, and the R&D cost SEK 105 million.

The company started the development of the biosensor technology which searches for and supervises the combination of the bio-molecules on the basis of SPR (Surface Plasmon Resonance) which consists of three component technologies of surface-chemistry, flow system, and optical detection in 1989. The company developed, manufactured and sold the first analysis apparatus in 1990, and attained black-figures and enforced its independency in 1994. And it realized the SPR array chip as breakthrough in the protein research in 2000. The present focus is put on the pharmaceuticals industry and on the discovery support of the new molecule as a drug candidate. As a latest innovative application example, there is a case of the drug candidate for kidney trouble treatment of the autoimmune disease patients by U.S. La Jolla Pharmaceutical. Although the third phase clinical test was stopped for serious side effects to some patients by US Federal Drug and Food Administration, a Biacore system allowed the drug candidate to get permission of test continuation from FDA, by the ability to identify the patients who can continue to receive the clinical tests without being influenced of side effects, and avoided serious technological and financial damages. The company attained at going public at both Stockholm Stock Exchange and U.S. Nasdaq in 1996. The latest development result caused the stock price rise more than 400% in 2000. In this way, also in a drug development value chain, if it specializes in a specific niche good at its company and divides the work, it can participate in a drug development business even with a venture business.

3. Drug development process and business model of biotechnology venture

KB (Karo Bio) was established in 1987, has placed the head office in Novum Research Park near Huddinge University Hospital in a Karolinska Institute south campus as a university start-up and achieved IPO at Stockholm Stock Exchange on April 3, 1998. After Karo Bio USA was purchased in May, 2000, this company enforced the ability to discover fundamental curative drugs specific in the receptor and biological organization for main illnesses, based on the research results in the domain of the core receptor biology and medicine chemistry in Karolinska Institute and U.S. Duke University. Of more in 100 scientists of 135 company employees, about half of scientists hold PhDs.

3-1. Business Strategy

As KB strategy, it aims at the development of precision drugs to main common diseases on the basis of the domain of the core receptor and protein science. To verify its own technology and business concept, it manages the project and financial risks mainly through the partnership with the large-scale pharmaceutical companies.

3-1-1. Business Concept.

The core receptors which are the R&D focus of KB control the activity of the gene of a cell and many organs in the living body, and form the group of the proteins which have close relations between structures and functions. The targeted markets are the treatment drugs for women's diseases, metabolism diseases (especially diabetes and obesity), cardiovascular diseases, cancers, skin diseases, and ophthalmology diseases. While the large pharmaceutical partners may need average five new products introduction into market in order to maintain 15% of annual growth rate, the company continuously focuses on the drug discovery stage to the pre-clinical test, enriches the drug pipeline, and proposes that the large partners can concentrate on the clinical development and the sales of final products. Moreover, this specialization strategy to the core receptor and drug discovery stage is also aiming at risk reduction against the volatility related to the specialization by the parallel management of some projects and targeting each project to each specific effect indicate. Although the down payment, research fund, and milestone are obtained with the drug development like clinical development after the drug discovery through the partnerships with large pharmaceutical companies, the main value construction is dependent on the long-term income based on the loyalty from future innovative drugs.

3-1-2. Platform Technology.

As the necessary factors for the drug discovery, there are the discovery of a drug target and the selection of drug discovery technology. Although a drug target is usually a protein, it has the physiological and metabolic effects in the state of the specific diseases. The proper technology to drug discovery is a means which enables selection of the compound most promising for quick discovery of a chemical substance peculiar to a target for verification, and for clinical development. The core receptors as the drug target are included in a group of functionally and structurally related proteins. In the composition of a core receptor, the domain which combines with ligands (hormone and drug substance) attracts most attentions for the drug discovery, since the domain is connected with control of gene expression. The drug discovery technology of KB is based on four bases as structure biology, pharmacological and calculation chemistry, HTS (high throughput screening), and lead compound selection system, by making "NucRecDB" as a core receptor discovery database into a core technology. In the domain of structure biology, a core receptor is protein, and since it combines selectively and specifically with hormones and drug substances, an understanding of the 3-dimensional structure is indispensable to the design of a new drug, or the optimization of a lead compound. The company's main element techniques have the receptor-ligand structure and the molecular braille information. A single compound, CADD (Computer-Aided Drug Design), and combi-chem are contained in the domain of pharmacological and calculation chemistry. The BioKey technology which is expected to significantly contribute to HTS utilizes the established technology which is called the phage display used to specify the molecule probe specifically combined with the biologically related pocket or surface on protein. The lead compound characteristic evaluation system is important to select the most promising compound for pre-clinical research and clinical development. This company uses the tissue profiling for specification of the compound of the low possibility of side effects, the Molecular Braille technology for quick recognition of the receptor conformity which reacts to the influence of organization specification, and the Cell Braille technology for specification of the influence of the compound on the receptor function of a cell.

3-1-3. Intellectual Property.

The IP (Intellectual Property) strategy includes the medicine substance discovered newly, process, method, technology, clinical use method, isolated gene in the protection objects of IP, and investigates the continual predominance in a market, and the long-term success and profitability. The compounds, technologies, and use methods are contained in the main candidates for patents. KB has applied for the patents which cover all the new and a series of compounds internally developed can be the protection foundation of new drugs. KB has 22 patent families in this domain as of December, 2001. Although technology is an important business tool, since it can be licensed as service, it is needed for the know-how protection of the company. KB has 25 patent families in this field. The patents about the clinical utility which uses some compounds for the medical treatment of the specific disease are based on the information which became clear in progress of research. KB has 15 patent families in this domain.

For example, in the patent area relevant to the receptor, it has the patents relevant to the specific rights about the estrogen receptor beta (ER beta), and the structural aspects of ER alpha and ER beta. And, in relation to the thyroid hormone receptors, it is applying both the patents about the drug compounds, and their use methods for the medical treatment of various illnesses like obesity, heart arrhythmia, hypercholesterolemia, and liver diseases, and the patents about the design methods of the thyroid hormone receptor ligands. Moreover, in order to prevent patent infringements in the main international markets of a medical product, and the domain of discovery and development, it has contracted with the patent lawyer's office in Europe and the U.S.

Table-4: KARO BIO’S PATENTS

Category	Drug Compounds	Use Patents	Enabling Technology	Total
Patent Families	22	15	25	62
Granted Patents	42	3	83	128
Number of Cases	178	45	196	419

Source: Karo Bio Annual Report 2001.

3-2. Research and Development Process

The KB is focusing on the drug discovery aspect targeting on the core receptors, within the drug development aiming at the treatment for common diseases, and has strategic partnerships with pharmaceutical firms carrying out the clinical development and marketing. It has four sorts of project forms like the strategic partnerships aiming at the concrete clinical development by the partners, the internal projects which can search at each stage for partners, the exploratory projects which can be promoted to an internal project by the effects or validity verification of receptors, and the out licensing. The drug discovery process is started when a strong proof of the target protein having relationships with the specific illness exists. It means for KB to start the search for the compounds combined with a specific core receptor. Then, many of these lead compounds are chemically corrected by the test which acquires the optimal joint affinity in various cell and animal models, receptor selectivity, organization electivity, and effects. After that, the clinical test about validity and safety is performed.

3-3. Projects

As one of four sorts of project forms, firstly, it has 4 strategic partnerships with international pharmaceutical firms for development of the innovative medical treatment method for common diseases. Next, it has internal projects including clinical development, by focusing on the discovery stage of new drugs which uses the core receptors as targets. Thirdly, the drug candidates and technologies which are not suitable for internal projects may be out licensed. And fourthly, it has the exploratory projects in order to maintain the pipeline of the drug candidates in some new core receptor domain. Especially, in addition to the new effects of the existing receptors, at the exploratory projects, the discovery and characteristic inspection of new receptors are conducted. Since the drug development involves a high risk, the portfolio management with the project of four forms is performed.

3-3-1.Starategic Partnership.

Although the core receptors are important targets for metabolism diseases like diabetes, obesity, cancer, and atherosclerosis, and for women’s specific diseases, since the drug development accompanies high cost and risk, KB seeks the large pharmaceutical partners which undertake the clinical development in a specific domain, and is fundamentally specializing in the drug discovery from the strategic perspective. In many cases, a partnership is started from the drug discovery stage in a drug development process. In this time, while the scientists of a partner company provide for the selection of the optimal candidates of clinical development with important technical knowledge and resources, and the height of their devotion raises the success probability of a project. In addition, KB draws the strategy which raises the market introduction probability of projects, by running some partnership projects in parallel. As main recent occurrences, the new strategic partnership on the core receptors in atherosclerosis domain was formed with Wyeth (at that time American Home Products) in September, 2001. Among 4 partnership projects, the obesity project targeting the thyroid hormone receptor with Bristol-Myers Squibb carried firstly forward the compound to the clinical test phase I, then KB received a milestone payment. In addition, in February, 2001, this partnership was extended to include Molecular Braille technology, to specify the 2nd generation of the compound and to find additional effects. In the partnership for diabetes with Abbott, in spring of 2001, it succeeded in a world's first determination of the 3-dimensional crystal structure on the ligand joint domain of the glucocorticoid receptor, and could utilize now for the design of the compound which acts on a receptor selectively, and for the design of a compound with the anti-inflammation effect in internal project. And with Merck, it has kept the partnership on development of the innovative treatment drug to uncultivated clinical needs in the estrogen receptor domain for women's diseases since November, 1997.

3-3-2. Internal Project.

The KB maintains the portfolio of the internal projects which are in various preparation stages towards strategic partnerships. When the proof that a receptor is an important target for the specific disease exists, KB is sure of the competitive advantage, and there is a proof about the existence of the big potential market to medical drugs, the exploratory projects can be promoted to the internal projects. And when a monopolistic position is established and a clinical rationale is further supported with experiment data, marketing of the project to pharmaceutical industry is started. As the internal projects, each discovery and development project such as the project on an androgen receptor with a new male hormone (androgen) for hormone substitution treatment and with a new antagonist for prostatic cancer medical treatment, the project on a glucocorticoid receptor for anti-inflammation medicine with few metabolism system side effects, and the project on a thyroid hormone receptor for skin disease treatment medicine is proceeded. Among of them, the validity of thyroid hormone antagonist is already tested at clinical human skin research phase I-II.

3-3-3.Outlicensing.

Since the knowledge of each target function is required, the screening technology which depends on traditional biochemistry analysis obstructs the screening of a target with an unknown biological function, and consequently restricts the drug discovery. On the other hand, the foundation of the BioKey technological program for originally inside KB which enables the high throughput screening is proprietary BioKey molecule probe, even if it lacks the detailed functional knowledge about target protein. KB also develops towards the diversification of BioKey technology which is specialized in the use for GPCR. At each partnership, concerned people have succeeded by about 75% of probability at the specification of the BioKey molecule probe which has high affinity to the target chosen by the partner, and by about 85% at creation of the ligand substitution BioKey assay to the peptide specified as a target. As main license-out partners, it contains Aventis, Boehringer Ingelheim, GPC Biotech, NovImmune, and Serono International.

3-3-4. Exploratory Project.

Since the core receptor is mutually alike in the structure and function, it is easy for KB to develop the technology about an unexplored receptor quickly and to design a lead compound to it. The receptors treated by exploratory projects can be divided roughly into the traditional receptors like a thyroid hormone receptor or a mineralocorticoid receptor, and the orphan receptors. In the thyroid hormone receptor, it has projects about glaucoma, heart arrhythmia, and new effect. Although the receptors of which the natural hormones or vitamins are still unknown are called the orphan receptors, many of known core receptors are in such a state, and furthermore it is considered that there are also still the undiscovered receptors. Access to pioneering technology was indispensable to KB which is specializing in discovery and development of a new treatment drug. Then KB contacted the agreement that it can acquires the exclusive rights of many technologies including the Cellular Braille technology which the Duke university and Duke Univ. Medical Center of NC developed in May, 2001. Moreover, as its scientific network about basic research, Duke Univ., Karolinska Inst., Sahlgrenska Hospital, UNC, Univ. of Bochum, UCSF, and Univ. of York are contained. Although the net sales of the group in the 2001 fiscal year increased to SEK 136.9 million from SEK 100.6 million of the preceding year, the main reasons were caused from the down payment accompanying the new term research partnership with Wyeth (former AHP) and milestone payment from BMS. The increase SEK 146.9 million in expense was based on the costs relevant to the goodwill depreciation by the fiscal period change accompanying KB USA acquisition in 2000 and the new research partnership with Wyeth. The parent company made about one fourth of the debt total of the group to fill up in the stocks special liability reserve. As basically promising projects are included in the project pipeline of KB, and the importance of the drug development relevant to the core receptor is forecasted to increase in the future, the occurrence of new business opportunities will be expected with the progress of development. In the tendency of the shift of the large pharmaceutical firms into the clinical development stage within the industry, KB, as an individual company, by maintaining the relations with the academic network, adopts the evolution type of business model which screens and promotes each idea or project to exploratory project, internal project, out-license, or strategic partnership, responding to evolution of the project portfolio along the drug discovery/development process.

Conclusion

As a next-generation group of biotechnology ventures, the stem cell ventures and the nerve medicine ventures can be mentioned in Sweden. As, in the country, embryonic stem cell research is morally possible, and as it is considered as the research theme important also for healthy maintenance of the public, the stem cell ventures started in Stockholm or Göteborg are forming a unique position also in the world. For example, ventures such as Cell Therapeutics Scandinavia, Neuronova, and Ovacell were founded by the researchers of Sahlgrenska Acdemy or KI. Especially, Neuronova which is lead by Prof. Jonas Frisen of KI discovered first that an adult stem cell has the capability to produce other various organs. Carlsson Research was founded in Göteborg in 1998, based on the strategy which has evolved from research of Prof. Arvid Carlsson about CNS (central nervous system) or its disease relevant to his Nobel Prize in 2000. It is said that its original ISP (Integrative Screening Process) which functions through the completely new mechanism of the overlooked activity enables the innovative search of drug candidates. Although, for example, it is usually said for a High-throughput Screening process, to looking for one candidate from millions of compounds, the search of a candidate is enabled by composition of 50 -100 compound containing 16 by the minimum record at ISP of the company. While energy consumption, such as investment and development, follows on innovation, the anti-entropy state of the creative performance or sophisticated mechanism which produces innovations may arise also on each level of a region, an industry, and an individual company. For instance, there are such examples of anti-entropy as the industrial metabolism in a region, the form generating of the technology and the product by the development division of work within an industry, and the evolution of the business model accompanying the progress of the drug development process in an individual company. n this way, in a cluster, the entrepreneur of an original idea places own body into a suitable information network rather than is isolated. Next, with the drug development value chain of the long-term and high risk, even if the company specializes in a specific niche area, the risk dispersion by specialization, partnership, and whole network is possible. And in the development portfolio of an individual company like KB, even if it does not have the product revenue for ten years, it can survive through the uncertainty reduction by the parallel management of projects and the milestone management in the drug development process. Especially in order to evolve a business model, by changing technical information and financial capability, the role of business development becomes important.

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End Notes

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Spin-Out Business Model: A Strategic Tool for Innovative Growth, Entrepreneurship and Flexibility in the Service Sector

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Abstract

This paper explores the applicability and the current implementation of spin-out business models by global management consultancy firms (MCFs). The study is built on the notion that these service firms should continuously be prepared to innovate their business. Sometimes incrementally, but if necessary drastically. In order to survive and grow in a highly competitive environment they should use a business model that allows them to inject flexibility and leverage on their entrepreneurial and innovative capabilities on different levels. The theory of spin-out management and business models is used as a theoretical framework. In combination with an overview of developments in the management consulting sector, this framework provides the basis for analyzing the results of the empirical study.

Spin-out Management

Just like other forms of corporate entrepreneurship, spin-out management is an alternative way to growing via mergers and acquisitions, and joint ventures, to name a few growth vehicles [25] [50]. The motives for growing a business from the inside out include corporate profitability, generating strategic renewal, fostering innovation and gaining knowledge that may lead to future revenue streams [58]. Researchers have acknowledged the importance of corporate entrepreneurship as a growth vehicle and addressed it from various perspectives e.g., the relationship between parent and venture, performance of ventures [58] etc. However, on spin-out management - as a variation of corporate entrepreneurship - in the service sector little research has been done. The spin-out process has been discussed though with regard to high-tech companies, universities, laboratories e.g., as a mechanism to transfer technology [20] [27] [51].

Spin-out management is a growth strategy by which a company decides to mainly grow through spin-outs i.e., by separating a new or an existing activity from the core business while profiting from the parent's assets [29]. It is a form of focused entrepreneurship [8] whereby spin-outs are placed outside the core business as separate ventures and involve a specially formed team of people. The spin-out is supported by the parent through infrastructure, existing network, reputation and distribution channels. The parent is coordinating a portfolio of relatively independent ventures with their own budget, strategy, assets and balance sheet and do not fall under established norms and guidelines of a parent. This type of smaller but complete venture is appealing to organizations seeking continual innovation [30]. The challenge of managing them is providing them autonomy while at the same time maintaining damage control [50]. This way spin-outs may contribute to renewal or even to changes in the competitive game in an incremental or radical way. Spin-out management can occur in a company next to other forms of corporate entrepreneurship [54] and facilitates an opportunity to grow with new ventures outside the core business that operate autonomously but yet are part of a large company. It is only in the past few years that this new variation of corporate entrepreneurship has become increasingly popular [29]. The implementation of spin-out management brings at least three strategic advantages: growth, entrepreneurship and flexibility [46] [53] and can lead to a new business model responding to the call for companies to operate close on the market and to minimalise bureaucracy [45]. This type of business model allows entrepreneurial firm-level behavior that can be a path to sustained competitiveness among established firms [17] operating in a highly competitive environment.

In this paper a distinction is made between spin-out management and ad hoc spin-out activities. In the case of spin-out management, spin-outs are part of a company's growth strategy and therefore a continuous process of initiating new activities in stead of single events. Making it a continuous process facilitates for example learning

from disappointments that characterize venture activities [23] [37]. Furthermore, it enhances experience in venturing that may result in improvement of the performance of ventures [35].
There are two different forms of spin-outs: 'start-up spin-outs' and 'going concern spin-out's'. Start-up spin-outs are new business initiatives initiated by a parent. Going concern spin-outs are activities which were initiated by a parent company in the past and subsequently positioned independently from other activities. In other words, these new ventures initiatives can be internally focused towards a rationalization of existing activities or the promotion of new ones [8]. For a spin-out is required that the parent company owns a minimum of 51% of the shares and has a final say in the management of a spin-out [29].

As spin-outs are placed outside the hierarchic structure, it is possible to operate closely on the market [29]. This is precisely the reason why spin-outs are a medium for competing within a dynamic sector dominated by technology [51] and why it is argued in this article that spin-out management is an interesting growth vehicle for companies in other sectors operating in a dynamic environment [29].

Business model

Towards the end of the last century, competition took place in an increasingly competitive business environment by some referred to as the technological revolution [6]. This period was characterised by an economic environment subjected to fast and dramatic changes [12]. Moreover, together with globalisation, technological developments have increased the scope as well as the dynamics of the relevant environment for companies [5]. It is these developments in the external environment that have caused a revolution in the business world on all levels of a company and through all sectors of the business community namely vertical linkages between businesses and their customers, suppliers and employees and horizontal linkages between firms within or between industries [1] [6]. To adapt to rapid changes in the environment is both demanding for the hardware[1] and the software[2] of a company [40] i.e., managers must develop new tools, new concepts, new organizations, and new mindsets [6]. Managers (software) must for example develop a mindset that allows cooperation with competitors as well as traditional economic competition [6]. Structures (hardware) must for example shift from vertical traditional hierarchical organizational structures [15] to horizontal structures with decentralized decision making processes and cross functional teams [6] [36]. What is a business model? Especially in the non-academic literature reference is made to business models in what seems to be a fashionable way, sometimes even without a clear idea of what the term stands for (e.g., [19] [31] [43]). According to Amit and Zott [3] the business model depicts the design of transaction content, structure and governance so as to create value through exploitation of business opportunities. In this paper a business model is referred to as an organizational model oriented towards adding value to stakeholders by combining tangible and intangible assets[3] in a unique way. In this definition a business model is not refrained to a single company's boundaries and stakeholders refer to the network of the firm i.e., the network of suppliers, investors, customers etc. is included in the business model [26] [48]. The changes in the environmental context of large established corporations and the shift in their focus from tangible to intangible assets demand for different and more dynamic business models than the traditional ones [5]. They should be able to meet the demands of a dynamic environment and sometimes even allow different dynamic levels within a company. For example, whereas an extreme traditional corporation is hierarchical in nature prohibiting new venture creation, a strong intrapreneurial firm has a flat organizational structure with networking, teamwork, sponsors and mentors abounding [26]. It is in alignment with scholars reasoning that strategic analysis of business ventures have to move beyond the traditional conception of the firm as the unit of analysis [3]. Whereas Amit and Zott [3] suggest that this is the case for e-business ventures, it is assumed here that it should be applied for analysis of any kind of business ventures as the new competitive landscape applies for all organizations [6].

This new concept of the firm changed the competition game and may according to Penrose even "call for a new 'theory of the firm' in economics and changed views about the behaviour of markets and the effect of 'free market' competition" [45]. Her line of thinking has been supported by studies emphasizing that developments in the business environment e.g., deregulation, global competition, technological discontinuities, have changed the base for competition [6] [40] [47] [62]. In this paper it is argued that a firm's business model is an important locus of innovation and a crucial source of value creation for the firm and its suppliers, partners and customers [3]. This is the case on the level of the parent as well as on the level of its individual spin-outs, for which a business model proves to be a key-success factor [37]. Moreover, business models are not only a source for innovation, but are or should be subjected to innovation themselves [6]. They have a life cycle and should be adjusted at a certain point in time. This applies not only for high-tech companies [33], but for all companies operating in highly competitive markets [6] [29]. Furthermore, research studies in the past show that the most successful companies are those that maintain a workable equilibrium for several years or perhaps decades and are at the same time able to initiate and implement dramatic changes when the environment is changing [59]. Especially incumbents have difficulties in (radically) changing their business models in response to developments in their business environment. The reason is that they frequently lack capabilities of creating or adapting to innovations that require substantial changes in their organization [13] [33]. In other words, success formulas of the past may become the reason for failure in the future. With existing capabilities that have become obsolete and perhaps even a handicap, they may, for example, not be able to change their boundaries [1].

While spin-outs can enable incumbents to leverage the innovative and entrepreneurial potential of their dispersed assets [8] they, at the same time, create tension between managing existing activities to ensure continuation and focusing on creating something new [30] [56]. This especially is the case for spin-outs as they are part of the parent company [29]. Entrepreneurial management is different from traditional management [53] because it requires for example different control mechanism [50] and reward systems [10]. In addition to a flexible structure, it requires a delicate balance between managing existing activities (administrative management) and new activities (entrepreneurial management) [30]. Therefore, it involves both the hard- and software of a business model.

It is assumed in this paper that it is not the size, the life-cycle or the sector of incumbents that determine their competitiveness, but their business model allowing to inject their hard- and software with features like innovation, entrepreneurship and flexibility to survive and to revitalize them [9]. It is furthermore assumed that spin-out management can be a tool to do so [38]. In fact spin-out management combines the competitive advantages of incumbents and new entrants by allowing flexibility and leveraging on innovative and entrepreneurial capabilities. At the same time it provides the ability to profit from the advantages of the parent e.g., established network and financial resources etc. [41] without suffering from the potential inertia of incumbents. Furthermore, if implemented this way spin-outs can enhance team learning as an essential factor for continuous innovation because it enables managers to explore new growth opportunities without being frozen into existing ones that may limit progress [54].

Management Consulting Business

In this paper strategy consulting is referred to as a part of management consulting. Management consulting is defined as the provision to management of objective advice and assistance relating to the strategy, structure, management and operations of an organization in pursuit of its long-term purposes and objectives [28].

In time the added value of the service sector on the overall economic activity has increased. By 1999 the value of cross-border trade in services was about 20% of total cross-border trade [61]. It is the largest and fastest-growing sector of the world economy and providing more than 60% of global output [61]. In the year 2000, corporate strategy services had the highest growth rate of all European management consulting services and strategic planning was the most important consulting service in this section [22]. Paradoxical little research has been done for example on the growth and internationalisation of service firms [11] [32] [16].

The transfer of knowledge across national borders was facilitated in the post World-War II period by new types of organizations and organizational forms [24]. From the eighties of the last century on, international expansion was primarily driven by 'follow the client' strategy. Service firms followed their multinational clients abroad [16] as opposed to market seeking entries that involve more risk because there is less knowledge about (potential) customers [32]. However, both entries are common in the management consulting business.

Some scholars assume that service firms internationalise and become multinational enterprises for the same reasons that the manufacturing companies do [11]. Others focus on differences e.g., the fact that the manufacturing industry has more internationalised than the service sector and that even the largest service firms may have a relatively low degree of multinationality compared to manufacturing companies [16]. Both schools emphasize the need to further research the (international) service sector to keep pace with the size and the growth of this sector [11] [16]. In line with Contractor, Kundu and Hsu [16] it is assumed here that also within the service sector there are substantial differences between the various categories -e.g., capital or knowledge intensity- that may produce different results when executing research studies. For example the creation of new ventures may be easier when there is no need for large amounts of capital and 'only' involves skilled people. Management consultancy is a people-based [11] and knowledge-based [16] service category. Contrary to capital-intensive service categories, it is more driven by intangible assets and has a much lower fixed costs burden [16]. The barriers to enter in this knowledge intensive part of the service sector is low as it is not capital intensive. New entrants need skilled professionals rather than large amount of capital [34]. Notwithstanding its rapid growth in the past, as an important contributor to the overall economic activity, the forecast for the future of MCFs seems to be less bright. Despite early predictions of increased activity, the Institute of Management Consultancy reports that 2002 has been a difficult year for the sector [28]. The Institute further reports that there were perhaps 15% fewer practicing management consultants and a significant change in offering to deliver as the market changed. The decline in the market came after the Internet boom [22]. The industry is suffering from a decrease in corporate spending on consultants, large global top-tier firms are downsizing by cutting their staff and strategy consultants no longer dominate the information channels on the latest thinking regarding strategies, management models etc. MCFs' management ideas, models and methodologies are increasingly available to their clients through business schools graduates and top strategy firms' alumni working for them. At the same time the Internet has an important impact on strategy consultants' global playing field as well. It decreases, for example, the cost of searching for, collecting, and communicating information [1] [4].

Since the Internet is an information technology and strategy consulting business has a large information content, it can be assumed to have an impact on global MCFs' boundaries [1]. Technology while creating new consulting markets (e.g., e-business) encourages at the same time the obsolescence of professional services that can be easily commoditized [34]. Some argue that because of the blurring of traditional boundaries professional service firms, once defined by specialty, are surging into new businesses [34]. Others conclude from this that there has been a shift form general analysis to specialist insights and knowledge [18].

It is argued in this paper that developments in the business environment of MCFs can involve either expansion or shrinking of their boundaries depending on the business model that is chosen [6]. This line of thinking supports the development of large multipurpose organizations being replaced by networks of specialized organizations and competition taking increasingly place among networks in stead of atomistic firms [6]. This also means that a service firm can create a network of spin-outs around the core that are specialized in different kind of services and products to obtain competitive advantage vis-à-vis its competitors.

It seems that not only the content (e.g., specialized versus general) of services, but also the way they are provided to clients (e.g., big teams versus software program) have to be -sometimes drastically- adapted and changed according to clients' demand. This new demand from clients forces consultancy firms to reinvent themselves with new business models, skills, profiles etc. [22]. This may prove to be a difficult task for global service firms because -although the overall economy is increasingly dependent on services- the innovation processes in general remained oriented towards products [57]. Furthermore, professional service firms that are people based are extra vulnerable because their strategic obsolescence may not be fully apparent for years and only occur when it is too late [34].

Research methodology

The aim of this paper is to provide insight in the spin-out business model as a strategic tool for growth, entrepreneurship and innovation for global MCFs and this way to contribute to the limited research on services [e.g.,16]. Given the fact that the theory regarding spin-out management, related to a low-tech sector like the services, is an early stage, a case based approach is chosen as a research strategy along the lines as suggested by Eisenhardt [21] and Yin [60]. This type of research is especially appropriate in new topic areas as it has the likelihood of generating novel theory and creative insights arising from contradictory or paradoxical evidence [21]. This research study involves multiple cases –with the parent as unit of analysis- of management consultancy firms, which may enhance extending the theory to a broader range of organizations in this sector. A priori specification of constructs is used to help shape the initial design of the research study. From the literature two potentially important constructs are identified: (1) spin-out management as a growth strategy for global MCFs (2) the business model as an important locus for innovation of firms. The research is based on a combination of multiple data collection methods as it provides stronger substantiation of the constructs used [21] and acknowledges the fact that to add to theory building in the service sector requires not only facts and figures (hard data) but also soft data i.e., rich description for example form anecdotes to explain them [42]. Data was gathered from a literature study on corporate entrepreneurship in general and spin-out management more specific in relation to the construct of business models. Furthermore this data was applied in professional service sector, namely well established global strategy consultancy firms (incumbents) here referred to as global MCFs. Six global MCFs were interviewed in the years 2002 and 2003. The conducted six interviews were semi structured, two to three hours length, with partners and senior consultants involved in corporate entrepreneurship in general and spin-out management more specific. Tape recordings of the interview were made and transcribed verbatim. To what extent did management consulting sector make this research on corporate entrepreneurship a special case? First of all the service sector at large deserves to be more researched. As explained earlier global MCFs is an important category in this sector. The management consulting setting is especially interesting in relation to spin-out management as many firms of this category have contributed to the development of theory and practice of spin-out management, they should be able to draw from a wealth of experience for example with respect to translating theory into implementation of the spin-out concept (e.g., [2] [55]) into their own firms. Furthermore, the perceived threat of new entrants and decline of demand for services of these incumbents could be a trigger for innovation of a category of firms that provided their services in the same way for many years. The study has a number of limitations. First, a limited number (six) of MCFs was interviewed. Secondly, there has been only one unit of analysis. An important step in building knowledge about spin-out management in global MCFs would be subsequent research in other firms and researching the spin-out perspective in addition to the parent perspective [8].

Analysis of results

Six dimensions of spin-out activities

In exploring the implementation of the phenomenon of the spin-out business model, as a strategic tool for innovative growth for MCFs, this paper focuses on the following six dimensions of implementing spin-out activities:

- ?? Do MCFs innovate their business models?
- ?? What is the status quo on implementing spin-out activities by MCFs as part of growth strategy and business model versus on an ad hoc basis as single events?
- ?? What are the advantages of spin-out activities?
- ?? What are the disadvantages of these activities?
- ?? What are the key-success factors for implementing spin-out activities?
- ?? What are the lessons learned from implementing these activities?

Table 1 shows the main advantages, disadvantages, key-success factors and lessons learned mentioned by the six interviewed MCFs. With regard to all dimensions a distinction is made between firms implementing spin-out activities on an ad hoc basis as single events versus firms implementing spin-out management. The reason is that this is an important distinction in this paper with regard to the implementation of spin-out activities. After elaborating on the innovation of business models and the status quo of implementing spin-out activities by MCFs in the next two paragraphs, the other four dimensions of table 1 will be discussed.

TABLE 1: ADVANTAGES, DISADVANATGES, KEY-SUCCESS FACTORS AND LESSONS LEARNED FROM IMPLEMENTING SPIN-OUT ACTIVITIES BY MCFs

Spin-out activities	**Single events on ad hoc basis**	**Spin-out management**
Advantages	Professional development of people.	Recruit, retain and develop first league human assets.
	Retain talent.	Package knowledge in different ways.
	Develop and commercialize new business ideas.	Establish wealth creating pillar separate from income generating business.
Disadvantages	Cultural clash between parent and spin-out.	Complexity of managing spin-outs.
	Many failures, few successes (sometimes even just failures).	Danger of loosing mass and control.
	Conflict of interest between new activities and consultancy services to existing clients.	Decrease in motivation of consultants not involved in entrepreneurial activities.
Key-success factors	Selecting manager(s) with an entrepreneurial mentality and skills to manage a spin-out.	Team of people inside the parent committed to establish a spin-out.
	Relatedness to the core business.	Relatedness i.e., possibility of sharing resources.
	(Lack of) structuring spin-outs.	Perception of customers that spin-out is valuable and their willingness to buy product or service.
Lessons learned	Spin-outs should be part of growth strategy otherwise they risk being abandoned after a failure.	The bigger and more established units are, the more they end up killing off new activities.
	Innovation and corporate venturing activities suffer unrightfully under economic downturn.	The challenge is being serious about running spin-outs as venture activities versus treating each new venture as some kind of new department.
	Due to cultural differences between consultants and people with a more entrepreneurial mindset, spin-outs in the service sector will rarely succeed.	The need to run ventures with discipline regarding investments (rather fewer strong investments than many dispersed), commitment of senior management time (for counseling and coaching) and timeframes for performance evaluation (e.g., getting out to the customers as soon as possible).
	Relatedness to core business will increase success rate of spin-out activities.	Allowing time for a spin-out to become profitable with a minimum of a couple of years.

Innovation of business models

Based on an analysis of the literature on business models, it is concluded here that business models are an important locus of innovation [3] for all firms operating in a dynamic environment. Furthermore, from the analysis of the management consulting business it is concluded that firms in this sector are operating in such dynamic environment and therefore may need to innovate their business models to survive and to grow. It is assumed that spin-out management may be a strategic tool to do so by injecting these established firms with characteristics like flexibility, innovation and entrepreneurship. Although form the interviews can be concluded that flexibility applies both to their hard- and software (e.g., low hierarchical structure and flexible mentality of their consultants), four out of the six interviewed firms have a low degree or lack of the two other characteristics of corporate entrepreneurship namely entrepreneurship and innovative growth.

The innovation process is built on knowledge-intensive features and relying on individual human knowledge [30]. Both characteristics are highly valued and available in MCFs. But when referring to their innovative activities, a majority of interviewed firms (five out of six) mention entering new countries and developing new practices and not renewing their organization by changing their business models. Moreover, these models have been in place since their foundation. Although MCFs develop concepts to advise their clients on innovative processes by introducing spin-outs and other venture activities, the interviewed firms do not translate it -or only to a limited extent- into their own firms. It seems that their partnership structure and fee-based system are much more geared towards consensus and low risk behavior being a barrier for entrepreneurial behavior and initiating spin-outs [30].

As far as the hardware is concerned, the six interviewed MCFs have a non-hierarchical structure compared to incumbents operating in other sectors. Their corporate center and the rest of the company is one and the same, because in their partnership structure, all partners are simultaneously owner, seller of services to clients and leaders of the firm [34]. The difference and distinguishing characteristic of the business model of these firms is that they rely first and foremost on skilled and motivated professionals [34]. As far as the software is concerned, the firms perceive themselves as creative and innovative inherent to the type of people they hire ‘people constantly thinking about and analyzing for example business models while at the same time being used to applying it to their own firm’ as one interviewee words it. Although it is relatively easy for consultants –whether partner or not- to develop new activities in the form of new practices or starting a new satellite office, most of them (four out of six) nevertheless experience difficulties or lack interest in innovating their business models.

Two firms out of six have introduced distinct business models compared to their competitors. One of them is different in the sense that it has a distinct remuneration system i.e., performance in stead of the traditional fee-based system. The software in this firm has a more entrepreneurial mindset than the software of traditional firms. People in the firm refer to themselves as ‘business people’ in stead of ‘consultants’. However, the potential benefits of an entrepreneurial style are not fully explored, because the firm is convinced that it should profit more from its core activities and, therefore, engages only to a limited extend in spin-out activities that potentially could expand or change the firm’s boundaries. Consequently, the focus of its entrepreneurial activities is on advising clients rather than on stimulating consultants to take risks, to innovate and to be proactive with regard to activities affecting the firm’s boundaries.

Only one firm introduced a business model that facilitates continuous innovation also on the level of spin-outs and their respective business models. It has both a wealth creating and fee-based system within the same business model. The firm adopted spin-out management as its main growth strategy, which is incorporated in its overall business model. The firm treats its boundaries as porous in stead of solid. It introduced a network model of different companies (main pillars) and spin-outs providing its consultants with opportunities to initiate and to implement entrepreneurial projects continuously testing the firm’s boundaries. There is one important lesson that serves as major input for the design of its business model.

When the firm was designing its overall business model about twenty years ago, it analyzed competitors. In the 1980s some competitive MCFs were growing rapidly. All these firms had one particular problem namely that they could not convert into wealth creating entities. More than anything else they were income creators. Every ten or twenty years they end up the same way, namely one generation selling to the next. The first generation would take the money and the next generation would leave, the firms would subsequently fall down. Based on its analysis of these developments in the past, the aforementioned firm implemented spin-out management.

It created a business model built on both an income and a wealth creating pillar. Establishing its wealth creating investment business provides the opportunity to sell off subsidiaries in case the firm decides to cash on its wealth. However, it is never prepared to sell its core business, because 'it would destroy the firm's whole engine'. This way it manages the tension between wealth creating and keeping the community together. The firm is convinced that clients are 'increasingly frustrated with traditional consulting models'. Rather than injecting the firm in a later stage of its life cycle with spin-out activities to survive or to revitalize, a reason for most incumbents to engage in venture activities [9], the firm implemented spin-out management since its foundation in the 1980s.

In conclusion a majority of interviewed MCFs have, just like incumbents operating in other sectors, a lack of interest and/or experience difficulties in revitalizing themselves. They remain inert to changes in the environment i.e., changes in the competitive landscape are not a trigger for revitalizing their business models. Furthermore, for a majority of interviewed firms, innovation is seen as entering new countries or developing new practices and remains within the boundaries of their existing business models. Both firms that introduced a different business model from their competitors were stimulated to do so by opportunity to differentiate themselves from competitors and meeting client demands rather than by threat due to developments in the global external environment.

Status quo of implementation spin-out activities

Five out of the six interviewed firms implement(ed) spin-out activities on an ad hoc basis as single events. Two of these firms withdrew completely from spin-out activities after bad experiences in the past. One of them developed a number of spin-outs, already early in its existence, which turned out to be all failures. The other firm started its spin-out activities only during the Internet era and ceased to do so after the burst of the Internet bubble. The remaining three firms have developed on a limited scale spin-outs that still exist as separate companies after they were spun off. The economic downturn seems to be an important factor for a decrease in the spin-out activities of these firms. This is a remarkable outcome since a majority of them states that especially in the current economic environment, an increase of competition in combination with an economic downturn, companies in general should invest more rather than less in spin-out activities.

Only one firm implemented spin-out management as defined in this paper meaning that spin-out activities are mirrored in its business model and growth strategy. The firm groups them in a separate unit 'the new enterprise group', which task is to hide the new enterprises from the rest of the organization because its experience is that the bigger more established units are, the more often they end up killing off new things. The reason for this behavior is that established units are suspicious of the activities of spin-outs and try to control them, because some of these new activities may cannibalise existing ones. Spin-outs are separate entities and the parent company will deliver a non-executive chairman who will leave after a while. This firm allows spin-out development to take place at different levels both as official decisions of highest level and from spontaneous creativity of those below. It refers to spin-out management as a fairly informal process that involves an informal testing of activities by a senior management committee, which authorizes some activities to become new enterprises. This committee also tries to keep the new enterprise focused on getting out on the market place.

In conclusion, although all interviewed firms mention that spin-out activities can be an effective strategy for growth that companies should implement more often in the current economic environment, only one out of six currently applies spin-out management as an integral part of its growth strategy and business model versus single events and ad hoc activities. Despite their flexible structure, a majority of interviewed MCFs have a low level or lack of entrepreneurship and innovation, the two other characteristics of corporate entrepreneurship. The higher degree of entrepreneurship and innovation are the distinct characteristics of the two firms that implemented different business models form their competitors. One of these two firms introduced a spin-out business model allowing a continuous flow of entrepreneurship and innovation throughout the company that allows it to build attributes of corporate entrepreneurship [54], to increase venture performance that is the case after several venture attempts [35] and to learn from disappointments [37].

Advantages and disadvantages

As far as the advantages are concerned, authors often refer to 'revitalization of incumbents' (e.g., [9] [13] [37]), 'growth, flexibility and innovation' (e.g., [30] [44] [53]) as advantages of implementing different types of corporate entrepreneurship. However, a majority of interviewed firms mention advantages related to their human assets -i.e., recruiting, retaining and developing human assets- as the most important ones and therefore in many cases a prominent reason for engaging or having been engaged in spin-out activities whether on an ad hoc basis or as part of growth strategy and business model. The advantages mentioned by the interviewed firms in fact all require long term commitment to spin-out activities as they involve changes to existing resource configurations and routines [38]. This is in line with the firm implementing spin-out management but in contrast with those firms that engage in spin-out activities as single events.

As far as the disadvantages are concerned there is a clear difference between those mentioned by the five firms implementing spin-out activities on an ad hoc basis versus the firm implementing spin-out management. In contrast to the first category firms mentioning the cultural clash between parent and spin-out as a disadvantage, the firm that implements spin-out management views the clash as a positive element: 'Companies are always full of tensions and frictions, it is not whether they are there or not but whether you use them for creative purposes or not'. In addition this firm does not experience the clash between new and existing activities as a disadvantage, because most of its spin-outs are not as much cannibalization of existing units, but compliments for their existing services.

With regard to the record of failures and successes of spin-out activities of the interviewed MCFs there are two extremes. One extreme is the firm with experience in establishing spin-outs in the past aiming to use them as a source of revenue and technology transfer mechanism [51]. Their performance record is extremely bad in the sense that none of these spin-outs have become successful in the end. As the main reason for these failures, the firm mentions a cultural clash between the consultants from the parent and the more entrepreneurial people in the spin-out who are forced to cooperate. The other extreme is the firm implementing spin-out management with a continuous flow of spin-outs growing around the core. Most of the firm's spin-outs became successful in a relative short period of time. Where the literature refers sometimes to eight years (e.g., [14]) this firm has a record of spin-outs that become successful after a maximum of five years and signs for success appear already in the second and third year of their existence when they pass three critical tests of (1) knowing whether it is a valuable entity for customers, (2) people staying motivated doing a spin-out and (3) creating new knowledge. The reason for this success may be due to the fact that the firm is focusing on obtaining market share in an early phase, which may reduce the time it takes to reach profitability [7].

In general the disadvantage of 'large losses' and 'high failure costs' referred to in the literature (e.g., [7] [9]) may be limited in the service sector, and therefore not mentioned by the interviewed MCFs. The reason may be that it is perceived to be relatively easy in a knowledge environment to establish spin-outs, because it involves skilled people rather than large amounts of capital. This is in contrast with high tech firms where the need for capital is the most important barrier to establish spin-outs [51].

Key-success factors and lessons learned

All interviewed firms mention the key-success factor related to the software of their business models as most prominent. For the firm implementing spin-out management, the availability of a team of people inside the parent is a requirement for starting a spin-out. This does not mean that the entire team has to be recruited from inside, there may be a need to recruit people externally, but not a whole team.

The issue of relatedness, referring to how close to a firm's current activities spin-outs should be, also is a key-success factor mentioned by all interviewed MCFs, but the degree varies for the different firms. For the firms implementing spin-out activities as single events, the ventures' activities should be as close as possible to the core business and may not or only to a limited extent expand (and not change) the firms' boundaries. The firm implementing spin-out management specified this key-success factor to the extent that the desirability for it varies over the long run. The firm will not start anything that has zero relatedness, but in time the requirement of relatedness may be less prominent than in the beginning.

The literature is not conclusive on the relation between venture performance and high and low levels of relatedness between spin-out and parent [52]. Although Sorrentino and Williams [52] argue that in general there is no relationship between relatedness and the success at venture level, they at the same time confirm that when combined with intangible assets held by the parent, relatedness may determine venture success. Further research would have to be executed in order to find out to what extent this is the case for MCFs' spin-outs.

With regard to the relationship between parent and spin-outs, the six interviewed firms have different views. Whereas some firms argue that high degree of autonomy and distance between parent and spin-out is needed for the success of spin-out activities, another firm explicitly warns against physical distance as it will lead to emotional distance and finally results in lack of commitment from parent to support spin-out activities. Others refer to a 'dark hole' meaning that a parent looses control over spin-outs when they are put at distance.

The firm implementing spin-out management has gained experience over the years and seems to have found a balance in the relationship between parent and spin-outs. While maintaining a high degree of autonomy, there is a strong commitment to counsel and to coach (rather than to control) management of spin-outs if needed.

Also the literature is not conclusive about the relationship between parent and spin-out. Some authors argue that a close relationship between the two is threatening the venture's performance [25] [39] [49]. More recently authors argue that a close relationship between parent and spin-out is positively related to a venture's performance while confirming that the relationship evolves as the venture matures [58] and the importance of managing the extremes providing autonomy and maintaining damage control at the same time [51].

The main lessons learned are drawn from the two extremes i.e., the firm implementing spin-out activities on an ad hoc basis and a high record of failures respectively the firm implementing spin-out management with a record of almost exclusively successful spin-outs. These firms are the most experienced firms of all interviewed MCFs. Both categories of firms confirm that corporate entrepreneurship are long drawn processes [54]. It is in contrast with firms suggesting that a continuous flow of spin-outs would be self-defeating and that there should be no structure at all.

Conclusions

There is a difference between the interviewed MCFs in their advisory role on strategic issues, being at the forefront of latest thinking on and implementation of strategic issues such as corporate entrepreneurship, and their own venturing activities. While all interviewed firms underline the importance of spin-out management as a strategic tool for growth, innovation and entrepreneurship for incumbents operating in a dynamic environment, a majority of interviewed MCFs do not apply it to their own organization.

Just like other incumbents, or perhaps even more because the interviewed global MCFs have been successful for so many years without an urgent reason to change their traditional models, they remain inert to changes in their environment and have difficulties or lack of interest in adapting their business models. For the time being they seem to prefer building on their past of long-standing client relationship, reputation permitting them to charge premium fees and their partnership structure forcing consensus decision making rather than looking at new ways of responding to clients demands in a changing environment.

This attitude may lead to a lag between current and future performance and result in that they do too little and too late [34]. The most important reason for their inertia is not the hardware of their business model, but their software lacking entrepreneurial and innovative characteristics. This paper suggests that introducing the phenomenon of the spin-out business model for global MCFs may be worthwhile, and perhaps even necessary, for the survival and growth of these service firms. Additional research should further develop the concept of the spin-out business model tailored to the specific characteristics of this category of knowledge intensive and people-based firms.

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End Notes

[1] With the hardware is referred to the organizational structure of a company [29].
[2] The software refers to the management, leadership and employees of a company [29].
[3] Assets - intangible and tangible – are referred to as buildings, production lines, R&D centres, existing network, knowledge, experience of employees, brands, reputation, distribution channels, growth and competitive strategies, organizational cultures et cetera. [29].

Section 3
FDI & Financial Markets

Global and Regional Trends in FDI: “Myths” and Reality

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Abstract

The paper deals with the global and regional trends in the foreign direct investments (FDI) especially from the point of view of some potential benefits expected from them mainly by the recipient countries. In connection with individual benefits from FDI inflows, the paper tries to demonstrate that in order the particular benefits could become a reality it is necessary that the host country will prepare for the incoming investors among others also such conditions that the particular expectations could become a reality. Hence the success in achieving expected benefits from FDI inflows does not depend only upon their volume but also and mainly upon their quality that as a rule corresponds to the quality of conditions prepared by a host country for their inflows.

Introduction

It is already an undisputed fact that one of the main expected and desired outcomes of the whole ongoing globalization and regional integration has been an increased FDI inflows into the countries of their need practically all over the world. In this respect especially developing countries and countries in transition like those from the Central and Eastern Europe (CEE) have been among those who have often seen in FDI almost a “miraculous medicine” that could “cure” all deficiencies but also inefficiencies of their often very seriously undercapitalized and not the best handled national economies and thus to solve all related problems. As in various other similar cases also the whole area of FDI and their potential benefits have been accompanied by various “myths” and totally or at least partially justified beliefs that not always correspond to the particular reality of the potential FDI benefits.

In the next parts of this paper we will try to deal with some of the basic expected benefits from FDI in a more general context and will try also to justify what has to be done in order the particular FDI could bring the benefits as expected. In this respect, the main conclusions and recommendations as presented in this paper are drawn from the ongoing joint research project of the University of Bratislava and University of Pittsburgh on FDI in the Central and Eastern European Countries under the framework of the NISPA/NASPAA Program and being funded by the USAID.

Main Benefits Expected from FDI and What is the Reality

In this connection we have to stress that FDI inflows not always bring all the benefits as expected from their presence in the particular country. It is also important to realize that also in the area of FDI not always their quantity and/or volumes are the most important indicators on the success in FDI inflows. In most the cases much more important is rather their quality, development and innovation potential. In summary especially it is their value adding character. Some FDI apologetics would argue that FDI mean a long-term relation and thus also the benefits are not always seen immediately or not so soon. That is in principle true but equally it is also true that some FDI by their nature and their “value adding” potential just simply cannot bring the same benefits as some other kind of FDI. There is a lot of empirical evidence especially from the CEE countries that we just cannot expect the same benefits from the FDI coming e.g. through privatization of banks or coming into other similar sectors as e.g. from the so-called "green field" investments and/or investments into modern high tech and/or export oriented production, etc.

If from this wider point of view we assess the FDI inflows then we could come to the following main conclusions and/or recommendations.

FDI as a Source of the Readily Available Capital

The first potential benefit expected from FDI is that they are bringing into the country a readily available capital. In principle it is true, but if FDI comes to the country through the privatization of banks that before their sale to the foreign investors had to be "revitalized", their portfolio had to be cleaned of the so-called bad loans that are often higher than the FDI themselves. Then from the macroeconomic point of view there is not possible to speak about any readily available capital. If the re-vitalization of a bank has required e.g. over 30 billion SK and the incoming FDI was only about half of that amount then one could hardly speak about any readily capital. It is like to buy a foreign currency for the double of the official exchange rate, what under normal circumstances cannot bring to the buyer any of the expected benefits. Unless there would be a very beneficial purchase and/or import of some components or raw materials that could help to produce a highly profitable new export oriented production, but definitely the “revitalization” of relatively small national banks does not have any such an export oriented potential at all. Another important aspect of "readily available capital" is related to that important economic concept of " a capital" as such. Its substance is that those funds acquired through FDI have to be used as a capital i.e. for further investments into business, trade, production, etc. where it could be further accumulated, re-invested, etc. But if funds from FDI inflows are used as an extra source for various kinds of social programs, reforms, cleaning from debts, etc. then it is evident that in such a case FDI just simply cannot bring any of those benefits as generally expected.

FDI as a source of new technologies

The second potential and much expected benefit from FDI is that they will bring into the recipient country new modern technologies. Unfortunately we have again to state that in the countries with very low costs of labor and/or in the other words with the very cheap labor there is no specific incentive for foreign investors bringing in any new modern technology. As a rule the latest technology is a rather expensive component within the overall incurred costs for foreign investors thus they are rather conscious regarding the investment into new technologies as in addition they have to take into account also various other considerations. For example it is evident that with the new technology as a part of FDI there are related also various other extra costs that could make their overall investment a rather more costly and thus also less efficient. Such extra costs are related to the costs of: purchasing or hiring a modern technology or its production, its transport and insurance, preparation of the installation site, installation itself, testing and verification, training of the local workforce, etc.

The more sophisticated is the new technology the more expensive is also the training of the local workforce but also the costs of such a more qualified labor. In addition, it requires also a system of more complex and demanding system of maintenance, a supply of spare parts, quality requirements for the whole operation and utilization, etc. In addition, such a complex process of bringing in a modern technology means that the foreign investor has really to be convinced on the good and long-term perspective of the particular investment.

FDI and the R&D

With the previous benefit i.e. new technologies as a part of FDI inflows is very closely related also an another potential benefit and that is the so called R&D - research and development or FDI into the research and development facilities where in mutual cooperation foreign and domestic researchers would be preparing new technologies, new products, services, etc. and thus making the local production more competitive on the global or regional markets.. The investment into R&D are usually an qualitative addition to the particular modern innovative production so for the foreign investor it is quite logical that will try to place also the particular research and development as close to the actual needs of production as it is possible and desirable for their mutual efficient interaction. It is clear that the most of R&D facilities are not oriented towards some kind of sophisticated theoretical research but rather to very practical and pragmatic needs of the particular modern innovative production. The examples not only from the USA, the EU but also from various other parts of the world clearly demonstrate that combination of the foreign capital coming into the country through FDI and its combination with the local universities know how have been one of the most efficient ways how to get full benefits from FDI and also from local universities.

For example in the Czech Republic in Brno there has been the Czech Technological Park as one of the oldest and most successful of such enterprises in the country established directly in the compound of the Technical University of Brno and has been conducting its value adding R&D oriented activities in the close cooperation with the staff and the graduates of the particular University. The same example it is possible to find also in the Gyor Business Park that again is one of the oldest, largest and most successful parks in its category not only in Hungary but also in the whole CEE region. This innovation and development oriented Park has been from its inception closely cooperating on various R&D oriented investment activities with the local University of Gyor. And in order to have the good regional examples complete we add one also from Poland. The Katowice Special Economic Zone has also been - from its foundation in 1996 - very closely cooperating with 11 local Universities and higher education institutions based not only directly in Katowice but also in other major cities in the Province of Silesia. Hence, if the investment sites for FDI are too far or not linked directly with the local universities it is not possible to expect that the particular FDI would bring also anything from the area of R&D and thus also a possibility for utilization of the local research cadres. First of all it is again up to the recipient country to prepare such conditions and investment sites and opportunities that for a foreign investor it will be quite a logical step to establish there also its R&D facilities. It is clear that to offer for incoming FDI an industrial park somewhere in a “terra incognita”, far from any reasonable communication, transport and local research institutions is definitely not the way how to become attractive for R&D related FDI.

FDI and New, Especially Foreign Markets

Another important benefit expected from FDI inflows has been that they have to contribute to the opening of new markets especially for production being produced locally in the FDI sites. But in brief we could state that such a benefit is again not available automatically. It is possible to achieve it mostly only if and when the FDI are coming into new, perspective and innovative productions. It is more than clear that e.g. FDI coming through privatization into banks and other financial institutions have of course no evident potential regarding new foreign markets whatsoever. The same is also regarding some traditional industrial sites – so called brown field investments – as again if it is sector producing some products that has been difficult to place on the global markets like various iron and steel products, but also textile, footwear, etc. then even the FDI cannot help much in reversing such a situation. In this connection as the most illustrative example could serve the example of the Slovak Republic. Although in the last 2-3 years the country has received the record high FDI inflows at the same time it has achieved also the historically highest deficits in the annual foreign trade balances especially for the last two years 2001-2002. It is evident that if this benefit regarding new foreign market has to be achieved then it is necessary to support inflows of FDI into such prospective sectors like electronics, some kinds of consumer goods, recreational facilities etc. that as a rule could help to open foreign markets.

FDI and Integration into the TNCs

With the previous potential benefit of new markets is very closely related also an another important benefit and that being that FDI are an important vehicle also for bringing into the country the TNC i.e. transnational corporations as one of the most important symbols and actual dominators of the whole contemporary globalization. For example in this case the Slovak Republic is again among the least successful the V4 countries in attracting the TNCs. In order to be fair we have to state that especially during the last 5-6 years also into the Slovak Republic have entered numerous TNCs especially in the form of large chains of department stores. In most cases they really met expectations on the "green field" investments as in general they have built a new shopping malls mostly on real green fields on the outskirts of cities with new jobs, etc. But on the other hand it has also to be added that the opening of these big modern shopping malls have also to the large extent contributed to the liquidation of many small shopping outlets that just could not withstand the fierce price competition from their much bigger and stronger competitors hence in many cases they have just increased the numbers of unemployed people. In addition these chains of departments stores have except some positives brought in also some other negative factors as they to the large extent increased also import of cheap foreign goods that in many cases make the domestic production redundant and thus also increasing unemployment, etc. and/or they are forcing local suppliers into not the most favorable conditions in their business relations. Hence in many cases TNC are not creating new jobs but rather reducing them in potential competitors and/or local suppliers and local partners become a part of TNC but on the less beneficial side i.e. not as suppliers/exporters but mostly as importers of foreign goods that in many cases could be produced also locally.

FDI as a Vehicle for Clustering, Concentration, Matching and Various Other Programs with Local Businesses

Another important potential benefit expected from FDI closely related to the previous one has been the area of various matching, clustering, spill-over, integration oriented programs and/or processes between the foreign investors on the one side and local businesses on the other hand. One of the main positives of all these various programs and processes are first of all seen in positive effects of foreign investors and their business entities on the local partners who in general are supposed to serve for them as either suppliers or contractors, distributors, etc.

In this connection it is very important to have a good national strategy with various forms of matching programs that would help foreign investors to find their new local partners. In this case as a positive example we could bring the Czech Republic and its National Pro-Invest Agency Czechinvest Prague with its database of various categories of local suppliers, services, advisors, etc. It is again about the same. Foreign investors are used to some comfort in services for them and accordingly to that they make also their investment decisions. One cannot just expect that foreign investors will be main initiators of the matching programs; they are mostly their primary users. As a consequence, if such matching programs do not exist or not offered in the particular country then foreign investors rather avoid such a country or in the better case to the large extent they then prefer as suppliers or various other partners their former partners from abroad. That again is one of the cases where FDI are not providing otherwise an important potential benefit i.e. a gradual equalization in the overall standard of foreign and domestic businesses.

FDI and an Increase in the Quality of Locally Produced Goods and Services

Another important potential benefit from the FDI is their contribution to the higher quality of the locally produced products, services, etc. Thus also better opportunities are crated for acquiring new markets and that again leads to expanded production, more jobs, higher employment, higher and more stable incomes in the particular region and thus a higher domestic demand and again expended production, new jobs, etc.

Under normal circumstance it is almost an automatically achievable benefit as foreign investors bring into the host country their brand names, production standards, know how and thus also the required quality standards corresponding to the particular products on the global markets. But again in order to achieve this kind of benefits it is necessary to create also some necessary preconditions regarding availability of the necessary technology, qualification of the workforce, technological discipline, quality of the row materials, etc In view of this it is of utmost importance to prepare for foreign investors locally reliable suppliers, subcontractors, partners whose services would meet necessary quality standards according international standards like ISO 9002, etc. as otherwise, FDI will seek their suppliers from the outside of the particular region or country, etc. An increased quality of production has again a very positive impact not only on the volume of production and thus sales and exports but last and not least also on an increased employment. But again it is up to the local partners to create the particular conditions for achieving such an important benefit.

FDI and Respect for Intellectual Property Rights and Protection of Environment

In general, foreign investors with their know how, new technologies are bringing into the host country also a higher standard and respect for the protection of these i.e. their intellectual property rights. However, in most developing countries and countries in transition the general respect and legal protection and enforcement of laws are still rather low. One of the reasons has been that this kind of rights did not have a long history in these countries. Only after the demise of socialism and beginning of the transition to the modem market economy also this new phenomenon has come to fore. However, this area has still been rather underdeveloped and especially the respect for intellectual rights in such areas as music, video, software, games and their carriers like DVD, CD, etc. but also protection of brand names and trade marks in textile, garments, sport clothing and shoes, etc. have very often been violated. That of course has also impact on the foreign investors who in many cases just hesitate to bring with their FDI also their latest know how either related to the particular technologies or products. Hence, as a consequence, in many cases, FDI are hesitant and are not bringing into many host countries the latest technologies, productions, products that could upgrade and innovate the general standard of production, make it also more environmentally "friendly" and thus also creating for the country of origin a better position on the world markets and finally again an important impetus for growing production and new jobs. Hence it is again up to the host country to prepare such a legal environment for FDI that foreign investors will not be afraid to bring into the country the latest technologies but on the other hand also a technology that could be potentially environmentally hazardous.

FDI and New Modern Management Style and Business Ethics

New modern management style and business culture and ethics are another potential benefits from FDI inflows. The more FDI flows into the particular country, the more positive effects from the foreign investment sites are becoming available not only for the particular sites but also for the whole country. It is proved, that even one solid foreign investor in a particular region could positively affect the business culture and management style in the whole region. Of course all that only in case that the particular region has created good favorable business conditions for foreign investors. If that is the case then that foreign business entity can positively effect all its partners on the vertical as well as horizontal levels. First of all on the vertical level it means all suppliers on the side of inputs and all customers on the side of outputs. Among the most common methods in this respect are such methods and standards as Just-In-Time, TQM, ISO9002, etc. On the horizontal level the potential positives are also quite evident in case that there is created a healthy business environment with the fair market competition without clientelism, favoritism, corruption, etc. However, as in every problem area also in this one there is a potential danger – especially if there is again a lack of law and law enforcement policies in such important business areas like preventing domination on the market, monopolistic market power, price fixing - that this potential benefit turns to become a real threat to all above mentioned partners and competitors on the vertical as well as horizontal levels and finally the main victim of all these unfair business practices has been that one being most innocent and powerless - a final customer, client, user i.e. we all.

FDI as a Tool for "Physical Integration" of the Host Country into Ongoing Globalization and Regional Economic Integration

As we already know, FDI is one of the most efficient ways and means how to integrate host country into the processes of ongoing globalization and regional integration e.g. through TNC. Especially it is true as far as the so called "physical integration" is concerned. In general FDI is one of the most efficient ways and means how to achieve so called "physical" dimension of integration. The materialized FDI (i.e. according to the particular definition: a long-term relations and interests) coming from e.g. the EU to the host country are the best guaranty that there will be from the particular investors also a lot of interest in mutual integration of both countries. Big important (especially TNC) investors are able to lobby successfully not only towards their own national governments but also with the institutions of the EU and in particular at the Commission in order their FDI would be not only the most efficient and one of the ways is of course also integration of the particular host country into the same regional integration block without internal borders and with free flows of goods, investments, etc.

FDI and the Cross-Border Cooperation and Integration

One of the most important aspects related to FDI is also the so-called cross-border cooperation. From the world of FDI we could bring a lot of positive examples how important for a country's sustainable development is this kind of cooperation. For example Mexico's experiences how to lure FDI from the USA and also those from the thirds countries destined for the USA into its "maquiladoras" i.e. special economic zones on their common border is one of the most positive examples how to properly utilize the concept of cross-border cooperation. From that one we could learn also that such installations manage to lure both types of FDI. It means e.g. those from Hong Kong or Japan or South Korea but also from the EU that prefer entering an almost unlimited US internal market from more favorable production conditions existing on the Mexican side of the common border with the USA. And by a certain paradox the same side of border has been equally attractive also for FDI from the USA for about the same reasons as those of investors from Japan or the EU i.e. many comparative advantages that they could not acquire from operating directly on the US soil. And as mentioned also already, there has been at presence existing a serious spill over effect and FDI from the "overcrowded" areas on the Mexico-USA border have been moving further to the south of Mexico.

As we know FDI nowadays need also a little bit more than just rely on the strategically good location of the country. Perhaps it is still true in the terms of geography. However, as far as the FDI inflows are concerned in addition to the good geography it is needed to add something more tangible as special economic zones (similar to those in Poland or China), or industrial and other types of parks similar to those as in Mexico, Indonesia, Malaysia, China but also Hungary, Poland or the Czech Republic and so on and so forth.

FDI as the Most Important Vehicle for Regional Development

In general, regional development is considered as one of the main potential benefits from FDI inflows. Again as in the previous case, foreign investors have to be advised in due time on individual regions where and under what conditions they could place their FDI. According to many foreign investors as a rule they are mostly not coming to the particular region and even not to a specific country. Only on the availability of various sources of information they finally make their decision regarding the selection of the particular country and a region for their FDI inflows.

What is needed it is mainly to prepare a kind of regional development strategy and then also a suitable and efficient system of information for foreign investors in order they could learn all necessary information as they need for their investment decisions. First of all, foreign investors must be convinced by the host country or its regions that it would be worth for their business goals to invest right in this particular country and its regions. As a rule foreign investors are not behaving as business explorers, researchers or discovers of “terra incognita”. As one foreign investor put it quite clearly, they are also not a kind of charity. On the contrary they are businessmen who need to be navigated to the best investment opportunities for their capital and as a rule better ones than those in their home countries.

FDI and Creation of New Jobs

One of the weakest parts of many pro-investment strategies has been its insufficient orientation towards one of the most important potential benefits of FDI i.e. regarding the job creation. Unfortunately, again we have to repeat that if the growth in FDI inflows has been mainly through privatization and/or various forms of sale and acquisitions of the former state properties by foreign investors then the expected benefits in job creation is very hard to achieve. Especially in the case of the so-called "brown field" investments i.e. investments into existing facilities this kind of benefit is almost not existing. As a rule in such cases after the particular change of ownership, one of the first steps of the new foreign owners has usually been "rationalization" of the over-employment through reduction of the so-called redundant jobs. Due to this development then, FDI not only are not creating jobs but in many cases are on the contrary substantially reducing their numbers and thus directly contributing to the growing unemployment. As we have illustrated it also in connection with some of the previous potential benefits, many of them if not properly prepared and handled could in fact lead to the reduction even in the existing jobs. It is again a clear consequence of the low quality FDI coming into a country as simply only so-called "green-field" investments i.e. investments into new production facilities in fact have had a full potential for achieving the particular benefit in job creation.

However, in case if there are through the economic diplomacy opened sufficiently prospective foreign markets for the export then even so-called "brown field" investment are not leading towards any reductions in the so-called redundant jobs. For the small country like e.g. the Slovak Republic it is of utmost importance of having large enough foreign markets for the potentially growing industrial production, etc. as the domestic market is just too small for any more significant FDI. In view of this development it is an imperative to promote export as the main driving force also for production and through that attract also FDI that could contribute also to the creation of new jobs.

FDI is an Important Source for Higher Standard of Living, but Again…

Undoubtedly, FDI is an important source for achieving a higher standard of living. After all achieving this benefit should express the very purpose of all social activities and processes i.e. helping people in improving the quality of their life. After all, this last benefit in principle has been synthesizing if not all then at least many of the previous benefits.

Although, as we have demonstrated also in the particular parts regarding these and other benefits from FDI inflows, they all are first of all potential benefits only and not always and under any circumstances they turn also to become the real benefits. The same is true also regarding their synthesis into the higher standard of living of people as the result of FDI inflows into the particular region, country, etc. In general, nobody could deny such a positive impact of FDI on the standard of living of the local people. Without any specific research we could bring a lot of examples from all various parts of the world where thanks right to FDI inflows the standard of living has substantially improved. The standard of living in the Republic of Ireland, Portugal, and in Spain have been improved mainly thanks to massive inflows of FDI. The same is true also regarding Mexico, where the whole process of improved standard of living has started on the northern border with the USA and as the FDI inflows have been penetrating lower and lower to the south of the country thus also the standard of living has been gradually improving in the same direction. The standard of living in the large parts of the People’s Republic of China has been much higher in and around the special economic zones on the south of the country than in other parts of that enormous country. Singapore after the end of the colonial rule was destined to become a pariah among its neighbors with much more favorable natural conditions and resources. And just within two decades of its ability to attract record high inflows of FDI, the city-state has become not only the country with the highest standard of living but also a model for its otherwise in terms of natural resources much more luckier neighbors.

Therefore, with the full justification, the same positive effect of FDI could be expected also in any other part or region in the world including the region of V4 countries in general and the Slovak Republic in particular. It just requires having a sound national pro-investment strategy that will be not so much focused on the quantitative volume of FDI inflows but rather on their quality and potential for achieving a sustainable development.

Conclusion

In the previous parts of this paper we have focused on some more systematic approach towards FDI and their potential regarding a positive impact on various aspects of the overall socio-economic development. All these potential benefits could turn into reality only if and when the particular government administration will properly define its macroeconomic priorities and will create corresponding conditions for foreign investors. We have to realize that under the current ongoing globalization, the global market for FDI inflows has been – among others – characterized by a very though competition when more than 150 countries have been offering various kinds of incentives for foreign investors. Moreover, there have existed also more than 120 of various regional integration groupings of countries and of smaller regions. Hence if a country wants to succeed in such a global competition in attracting FDI inflows then one of the best ways to achieve that, it is to become a part of some regional/sub regional integration grouping of states. That is also one of the most efficient ways that also a small country could become a more attractive destination for FDI inflows. But again, only a membership itself even in the EU is not automatically securing that the FDI will start to flow to the particular countries as it is not also in case of a membership in the NATO, OECD or any other otherwise prestigious international integration blocks or organizations.

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Refocusing and Internationalization of Multinationals in the Wines and Spirits Industry

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Abstract

This research focuses on the governance restructuring strategies of the 10 top world multinational firms in the wines and spirits industry, over the last decade (1991-2000). Specific assets involved in all the restructuring operations led us to identify and explain the dominant forms of governance and corporate strategies in the industry.

Introduction

During the 20th century, an increasing number of wines and spirits firms broke the boundaries of their regional markets and created brands for the national market. However, it was only in the last two decades when the top multinational enterprises (MNEs) truly expanded throughout the five continents. Yet, most of the top world MNEs is still located in the Triad (Europe, United States and Japan). More recently, giant companies with sizeable capital resources penetrated international markets through subsidiaries, joint-ventures and licensing agreements. Therefore, since the 1970s, concentration in the wines and spirits industry became more conspicuous than in other alcoholic beverage industry. This change was engendered by rapid metamorphosis in output (via expanding economies of scale) and marketing technology (Wilson and Gourvish, 1998). Many of MNEs are vertically integrated from raw material processing through wine production, brand ownership and marketing (e.g. Ernest & Julio Gallo).

The metamorphosis operated in the competitive forms lead MNEs to adopt more flexible modes of organizing with simplified structures in order to become more reactive to the demand for F&B. This industry is a mass consumption industry and its increasing power induces a progressive disappearing of the auto-consumption productions and the decline of the agricultural activity in modern Societies. Moreover, a great diversity of F&B consumption patterns persists across the countries, depending on cultural traditions and the local production potentialities. However, if globally the F&B consumption increases slowly, significant differences exist among products. Thus, in the last few years, one sees an increasing in the convergence of world consumption patterns, amplified by the development of eateries and, simultaneously, strongly resisting to local specificities (Rastoin, 2000).

This work is structured as follows. In part 1, we present the competitive environment of the wines and spirits industry and the 10 top world MNEs. In part 2, based on the works of Williamson (1975, 1985) and Dunning (1993), we build a typology of the internationalization and governance strategies of the MNEs. Finally, we discuss the factors constraining the emerging of the hybrid forms of governance.

1. Emerging of new "hybrid" forms in the wines and spirits industry: between financial constraints and reactivity

The years following the World War II were characterized by the emerging of big industrial and financial conglomerates which held steady relationships with the competitive environment (customers, suppliers, etc). Following the progressive liberalization of the markets, le rise of new information technologies (IT) (intranet, EDI Electronic Data Interchange, ECR Efficiency Consumer Response,…) and the incapacity of the Fordist model to produce the desired outcomes, firms started questioning about the nature of their procedures – basically the strategic planning – and to pay more attention to the process, i.e. "to the chains of finalized actions" which looked to change the conditions of insertion of the firm in the competitive environment (Lorino, 1998; Tarondeau, 1999).

This new environment imposes two new main constraints to the firm: a financial constraint and an innovation constraint. The first one is mainly related to the minimal thresholds to reach in the value creation process. The pressure exerted by the financial lenders (banks, insurance companies, pension and mutual funds…) motivates the firm the rethink its modes of governance and financing.

1.1. Restructuring and oligopolistic rivalry in the global alcoholic beverages industry

A high concentration level combined with a strong market power and a closed oligopolistic structure characterized for many decades the oil and non-iron metal industries (e.g. aluminium, nickel). The main feature of the actual phase of capital globalization is the extension of the supply side with high levels of concentration in most industries of "high technology" or mass production (Chesnais, 1997). Following a trend of simultaneous crossing international investment and mergers and acquisitions, the concentration level of the world industries in the manufacturing industries is very high today (e.g. at the beginning of 2002, the top 10 MNEs in the brewing industry accounted for more than 39,4% of the world market). Therefore, a substantial part of the restructuring operations in the alcoholic beverage industries mobilize more and more high level funds (thus, the joint acquisition of the Seagram's assets by Diageo and Pernod Ricard reached 8,15 billion $US), and from other side new strategic formulas are used by firms to avoid entering under the law abuse of dominant position (technological or commercial agreements) and of too expensive purchases of assets (share exchanges).

The existence of oligopolistic situations cannot be apprehended by simply analyzing the high level of concentration rate in the industry. The most general assumption, and also the most prolific, of the oligopoly is based on the interdependence that exists among firms. Thus, most often, some mimetic effects arise among firms because "*firms do not react to the impersonal forces issued from the market but personally and directly to their competitors*" (Pickering, 1972). That is the reason why some authors consider that the world oligopoly is like a "*rivalry space*" in which the boundaries are delimited by some mutual (inter)dependent relationships that interconnect a small number of big firms. These firms get, in an industry (or in a complex setting of industries with a common "generic" technology), to buy the status of effective competitor in a world basis.

The oligopoly involves simultaneously competition and co-operation among MNEs. These firms recognize their mutual interdependence through all kinds of contractual agreements (technical co-operation or setting joint technical standards and rules) and most of them avoid entering into conflict with the anti-trust legislation[1]. By its nature the oligopoly is an "excluding" entity. Of course, the firms that are the most affected by its effects are those from the most vulnerable countries – with the exception of those firms becoming attractive by the specific technological knowledge they hold. Many small firms survive, the only way to survive is to the "adhesion" to a network organization that means the transformation of their status in sub-contractors.

One generally agrees that the process consists of a "decomposition and re-composition of the oligopolies", as it was described by Delapierre and Mytelka (1988). It is a permanently combined process. The decomposition follows the impact of technical change whose rhythm and trajectories are also very strong and fast. Most often, the oligopoly combines both dimensions of competition and co-operation (e.g. the case of the distribution network Maximum following an agreement between Fortune Brands and Highland Distillers or, also, Triodis in France – Bacardi Martini, William Grant & Sons and Rémy Cointreau). Those are very strong means of oligopolistic rivalry having important consequences over some MNE. The agreements and partnerships among firms almost equal or those concluded by smaller firms that fight to get the access to oligopolistic markets dominated by firms very well established in those markets should be perceived as "an extension of the competition but by using other means". By opposition to the traditional joint-ventures, strategic alliances are not necessarily built to last a long time. Motivation of the partners can be aggressive or defensive – protecting the core business – (Hagedoorn and Dysters, 2002).

The strategic map of the alcoholic beverages industry, as most F&B industries, is structured in an oligopoly with "fringes" that is progressively reinforced. For e.g., in the wines and spirits industry, several mergers and acquisitions changed the structure of the industry:

- Constellation Brands (USA) buys BRL Hardy (AUS) assets (2003) ;
- Diageo (GBR) and Pernod Ricard (France) spin-off the assets of Seagram (Can) (2001) ;
- Merger between Guinness (GBR) and Grand-Metropolitan (GBR), giving birth to a new entity named Diageo (1997);
- Merger between the assets of Allied Lyons (GBR) and Pedro Domecq of Spain (1994) (now Allied Domecq);
- Merger between Bols and Wessanen (Netherlands) (1993);
- Merger between Bacardi (Bahamas) and Martini & Rossi Spa (Italy) (1992).

Taking into account the recent trends in the industry it seems that this movement is yet far from its end. These restructuring operations have major consequences in terms of corporate governance implications, namely in terms of the iterations between managerial strategies and the constraints derived issued from governance structures. That could be established at two different levels: upstream and downstream. At the upstream level, these operations have a major strategic impact and the question of managers' discretional behaviour – the role of incentive and control mechanisms – to achieve those major projects seem essential. At the downstream level, because these operations lead to new adjustments of the corporate governance structures in the MNEs involved in such operations. Mergers involving big firms from different countries raise the question of the pertinence of national borders in the determination of the discretional managers' discretional behaviour (Boissin et al., 2001).

1.2. Is nationality a discriminating criterion of the strategies followed by MNEs?

Based on the analysis of the externalization strategies and on the specificity of the assets used by the top 10 MNEs in the wines and spirits industry, we tried to assess the differences/similarities of the different "worlds" of MNEs (see table 1)[2].

TABLE 1: TOP WORLD 10 MNES IN THE BREWING INDUSTRY

USA	Europe	Japan
Bacardi-Martini	Diageo (GBR)	Suntory (USA)
Fortune Brands	Allied Domecq (GBR)	
Constellation Brands	Pernod Ricard (France)	
Brown-Forman Corp.	Rémy-Cointreau (France)	
	LVMH (France)	

Note: Our criteria took into account only the weight of the dominant activity (wines and spirits).

The alcoholic beverages industry is largely dominated by MNEs from the Triad countries, even if new actors appeared in the last decade (e.g. in 1998 the merger between Brazilian Brahma and Companhia Cervejeira Antarctica created Ambev, the main beverage company in South America) or at the beginning of this decade (at the beginning of 2002, the Canadian Molson acquires the second Brazilian brewery Kaiser and, more recently, South African Breweries buys Miller Brewing transforming itself in the second world brewing company). Some other MNEs decided to divest their assets in the brewing industry: Bass Plc sold in 2001 its brewing activities and the group was renamed "Six Continents" (hotel chains). The acquisition of wine firms Beringer (USA) and Mildara Blass (Australia) led Foster's Brewing Group to be renamed Foster's Group Ltd (specialized in the alcoholic beverages industry) (2001) (see table 2).

With the exceptions of Bacardi-Martini and of Suntory, all these MNEs are public companies. The need to increase its size and the need to stay attractive to corporate investors are, most often, the two main arguments to go public. Therefore, those firms are subject to shareholders' pressures

TABLE 2: TOP WORLD LEADERS IN THE WINES AND SPIRITS INDUSTRY AND ITS DYNAMICS OF RESTRUCTURING (1991-2000)

MNE leaders	Characteristics			Number of restructuring operations			
	Country	Zone	Sales 2002 (consolidated millions $)	1991-1995	1996-2000	Total	Tot. alcohol
Diageo	USA	NA	17 276	46	72	118	40
LVMH	FRA	EU	13 304	26	135	161	27
Suntory	JAP	AS	10 870	26	38	64	12
Fortune Brands	USA	NA	5 678	15	22	37	2
Pernod Ricard	FRA	EU	5 069	43	59	102	44
Allied Domecq	GBR	EU	5 163	46	64	110	38
Constellation Brands	USA	NA	3 634	9	10	19	14
Bacardi-Martini	USA	NA	3 200	15	23	38	26
Brown-Forman Corp.	USA	NA	2 208	19	21	40	17
Rémy-Cointreau	FRA	EU	887	38	34	72	33
TOTAL				283	478	761	253

Source: annual reports, business magazines.

The last decade was also characterized by a new reorientation in the restructuring operations of the alcoholic beverages industry. First of all, we noticed a strong increase in the operations of external internalization ("hybrid" forms), which means a new search for more strategic flexibility because, as a consequence of the specific strategic assets involved, these operations are less restrictive in terms of the irreversibility of the investments carried out.

A previous comparative analysis of the strategies of the top MNEs in wines and spirits industry led us to identify two strategic trends: specialization (Bacardi-Martini, Pernod Ricard, Rémy-Cointreau, Brown-Forman Corp.), diversification (Diageo, Allied Domecq, Fortune Brands, Suntory and LVMH). Seagram could be considered as a specific case and finally this MNE sold its assets to Diageo/Pernod Ricard. However, at the beginning of the new century, one notice that Pernod Ricard develops a new strategic intention (divestment of non-alcoholic assets) and of Diageo (divestment of Pillsbury) (Coelho and Sousa, 2000).

The international expansion is followed by a new trend in geographical restructuring, leading MNEs to invest more and more in countries where the demand for alcoholic beverages is strong (essentially, it concerns South America and Asian countries).This new geographical restructuring is closely linked to the deceleration of the consumption of alcoholic beverages in low income countries and also to the changing of habits consumption (new patters of consumption are emerging with a special interest to the new market niches like the long drinks, low-alcohol beverages, functional beverages,…).

Finally, the (premium and super premium) brands and distribution networks are also two new keys in building of competitive advantage. Essentially, the top brands in the alcoholic beverages industry (wines, beers and spirits) are controlled by a short number of MNEs. In this specific case, the MNEs try to acquire and /or control a portfolio of international key brands, covering almost all market segments for each one of the beverages (e.g. draft beers, light segments, pale ale,….). At the world level, competition among MNEs is driven by a small number of international brands, having a strong market share or dominating several market niches (a strong position in a specific market segment).

The building of some distribution networks at the world level is also another essential factor of competitive advantage to approach the different markets. Two basic factors explain the interest of the network activities. From one side, the search for synergies between production and distribution activities (distribution networks allow to MNEs to benefit from the synergies common to a wide range of beverages). From other side, MNEs avoid to be dependent of other entities to distribute their own beverages because the unexpected lost of an independent distributor in a country could imply the lost of the entire market). Distribution networks are characterized by a specific phenomenon leading MNEs competitors to co-operate (see examples above).

2. Internationalization and governance forms of MNEs in the wines and spirits industry

By comparing the characteristics of the restructuring operations – degree of international orientation (in/out) versus the governance forms (hierarchy/hybrid) – the purpose of our analysis was to build a first typology describing the trends of these MNEs to adopt a "network" form (see Table 3). This typology is an adaptation of the "eclectic paradigm" (or "OLI" paradigm), described by Dunning (1993), and explains the main alternative firms have to enter in foreign markets. Dunning considers that firms have three main advantages to become a MNE: the specific advantage related to intangible assets (O for Ownership Advantages), location in foreign markets (L for location advantages) and the advantage related to the internalization (I for internalization advantages). Each type of advantages is linked to a level of analysis: O to the market structures, L to the comparative advantage of the foreign country, basically in terms of production, distribution and transport costs. Finally, I am linked to the organizational behaviour of the firm.

Therefore, the variables OLI will be influenced by the structural characteristics of the foreign country, of each industry and of MNEs. Several interactions among these three variables are possible. This approach is based on the implicit hypothesis of a strong dichotomy between the hierarchy and the market. The complementarities with the work of Williamson, allows us to model the process by integration the intermediary forms of governance ("hybrid forms").

TABLE 3: INTERNATIONALIZATION AND GOVERNANCE FORMS (1991-2000)

	Hy > Hi	Hy < Hi
In > Out	3	Allied Domecq LVMH Rémy-Cointreau Constellation Brands Fortune Brands
In = Out 1	Suntory	
In < Out 2	Bacardi-Martini 4	Diageo Pernod Ricard Brown-Forman

Legend: number of operations « in » = inside the zone and «out » = outside the zone; « Hy » = hybrid forms and « Hi » = hierarchic forms.

Note: The degree of internationalization is measured by the number of restructuring operations outside the "domestic" zone of each MNE, i.e. the domestic market enlarged. For e.g. for Pernod Ricard it would be the European Union and for Suntory Southern Asia.

All the restructuring operations were classed for the period 1991-2000, for each one of MNEs, by taking into account the criteria of the nature of the "specific assets" involved (see Williamson, 1985) and the location of the operations. Based on these two criteria we built a typology of the organizational and geographical frontiers of MNEs.

"Network"-based MNEs [Type 1 (In = Out; Hy > Hi); Type 2 (In < Out; Hy > Hi)].

The first results show that Suntory and Bacardi-Martini in the alcoholic beverages industry practice further the strategies of external internalization. In fact, Japanese MNEs tend to favour the "hybrid" forms of growth, even if these firms follow strategies of diversification outside the alcoholic beverages industry (functional foods). Historically inserted into organizational forms very specific – *keiretsu* – and dependent of the domestic and/or regional market, these MNEs have considerably increased their internationalization during the 1990s: Suntory became of the major actors in the bottled water industry in the United States and its Japanese direct competitors invested mostly in strategies of regional expansion in the Chinese and Indian markets. However, foreign direct investment in the Chinese market is greatly conditioned by the joint presence of local partners in the ownership structures.

Bacardi-Martini sustains its international development through the signature of license agreements.

"Hierarchy"-based MNEs [Type 3 (In > Out; Hy<Hi); Type 4 (In < Out; Hy < Hi)].

European MNEs have a dominant orientation toward the hierarchical modes of governance. These forms of investment are less reversible as a consequence of the presence of sunk costs. However, this analysis should take into account the level of concentration of the various sub-industries (in Europe, in the high-yield countries, the brewing industry is still in a phase of consolidation and rationalization).

MNEs of "type 4" follow their international expansion through the realization of very specific investments: the acquisition of production activities in foreign countries is the main mode of development.

These results are confirmed by the analysis of Figure 1. As in table 3, the same type of strategies can be identified and a clear opposition between "network-oriented" and "hierarchy-oriented" MNEs.

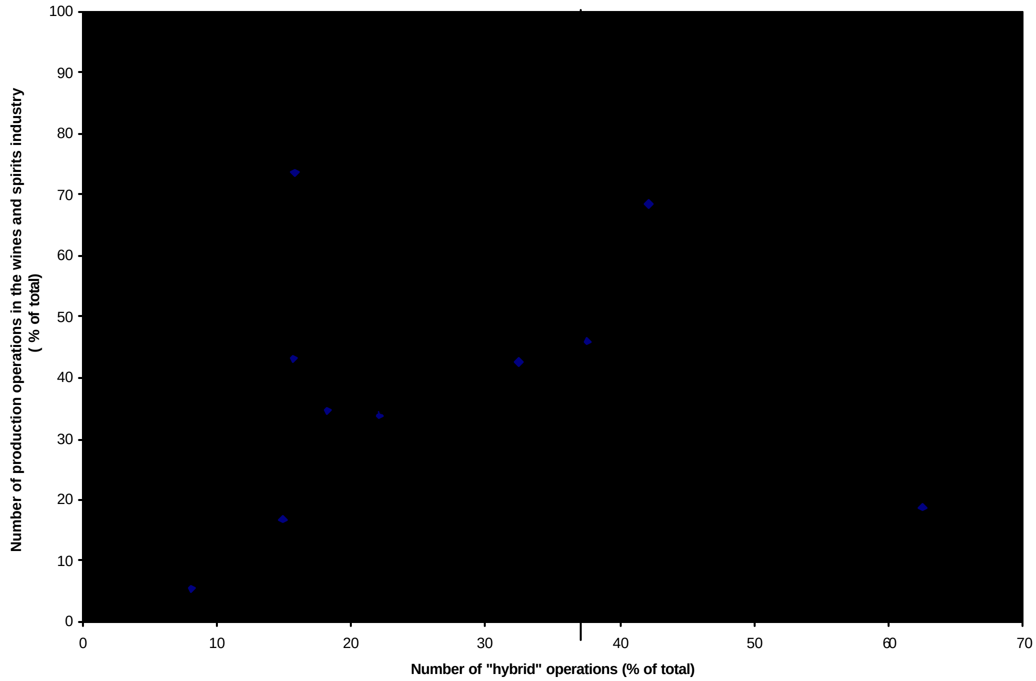

Figure 1: RESTRUCTURING OPERATIONS IN THE WINES AND SPIRITS INDUSTRY AND THE RELATIVE IMPORTANCE OF “HYBRID” GOVERNANCE FORMS (1991-2000)

Note: the full range of « production » operations comprises also plant closures and the disposal of assets.

The choice of network forms it is not insignificant: the main goals remain a greater internal and external flexibility and an increase in reactivity to the demand for alcoholic beverages. MNEs in the Japanese brewing industry are a good example of this trend. Between the Second World War and the end of the 70s these firms competed in an oligopolistic environment, stable and much protected by entry barriers in which competition was not based in prices. Since the mid 80s the competitive environment changed – hyper-competition phase – and, more and more, these MNEs move toward network forms of organization (D’Aveni, 1944; Craig, 1996). Therefore, these MNEs develop new organizational competencies in order to initiate or react to the new forms of competition. Also, the specificity of “network-oriented” MNEs is the coexisting of competition and co-operation strategies in the same industry.

In short, one could say that the external coherence modes of governance (Cohendet and Llerena, 1999) of MNEs in the alcoholic beverages industry vary significantly across MNE, depending on their geographic origin (for e.g., in the example, the strategies of European and Japanese MNEs are quite different). This idea should be considered with precaution as the destabilization of economic structures in some countries, whereas Japan is the most obvious recent example, lead to big metamorphosis in MNEs co-ordination modes with their competitive environment. Therefore, the liberalization of the Japanese market in the context of the World Trade Organization (WTO) should influence the coherence modes of governance in this market.

Network-organizations are characterized by a centralization of some activities of the value chain (financial reporting, computer services, HRM, R&D). Several other activities are managed directly by subsidiaries (e.g. marketing services). The adoption of a global information system allow to the different plants/services to communicate the information in real time to the holding company or to the strategic subsidiaries. The coherence of the global system is ensured by several “strategic points” that take into account the core competencies of the organization. The pertinence of the mode of organization is consequently verified by an increased efficiency of management.

The difficulties of putting networks to function are explained by the intensity of competition among MNEs. This could be explained by two main reasons. First, results show that in the industry exist less hybrid forms than hierarchical. Therefore, competition intensity will remain high because hybrid forms should constrain or reduce competition among firms. Thus, more MNEs are integrated more competition is intense because MNE tend to dominate the entire beverages chain (e.g. production and bottling operations, distribution networks). Secondly, concentration in the industry increases. This leads us to the question to know whether competition is more intense in an oligopoly (with "boundaries") than in an atomized structure. We agree to answer positively to the question because market pressures and more and more important and investors' activism have an influence at the "meso-economy".

2.1. Factors constraining the emerging of the network -organization in the beverages industry

Several factors explain the difficulties of MNEs in this industry to converge toward network-organizations. First of all, this is a mass consumption industry in which the demand is more and more volatile and in which a great number of goods have short term duration. Most often, raw materials are biological in the essence and thus difficult to standardize and industrialize (the all range of activities is more or less "cyclical").

"Psychological" factors play an important role in guiding firms' behaviour because firms are in general very individualist. The psychological profile of managers is also an important barrier (e.g. as far as we know the network of peer managers does not exist in this industry).

Also, the own nature of distribution networks, through the hyper-competition verified in the downstream of the value chain, hinders the emerging of truly co-operative organizational forms among firms.

Traditionally, this is a low-tech industry (low ratio R&D/sales). Generally speaking, the progressive introduction of biotechnologies, the pressures motivated by globalization lead MNEs to better control the processes and to exploit appropriately scale economies, to ensure food safety and a minimum of nutritional guarantees, to provide a new generation of functional beverages and to respond to the demand of consumers looking for convenience foods, variety and quality. All these elements will unquestionably conduct firms to intensify their R&D efforts.

At the same time, the changing of demand and food and drinks life styles led to increasing market segmentation (hyper-segmentation) increased the turnover of products and the development of transnational segments of food and beverages consumers. The reactions provided by firms were not only the introduction of new products but also a better focus in national and foreign consumers' expectations. All of these imply necessarily an improvement in the market and R&D competencies of MNE (Traill and Meuleberg, 2002).

Contrary to other industries, the food and beverages industries are characterized by a stable and cumulative technological process in which past innovation determines strongly the future path of innovation. At the same time, the pattern of innovation varies inside this industry. The learning experience curb of the "design" function is quite important in high manufacturing industries but has low significance in the basic food products. Firms' size is not very important in this process (Alfranca et al., 2002).

Most often, the introduction of new information technologies in this industry tries to improve the effectiveness of the global supply chain – basically it concerns the relationships with the downstream activities and to a less extent the integration of the various upstream and downstream functions (Craig and Hill, 2002). Finally, Gereffi and Korzeniewicz (1994) consider that the structure of the industry is determined by the type of goods or services produced as a consequence of the diversity of existing commodity chains, giving the possibility to a large number of firms to enter and to improve their positioning in the global division of labor.

Conclusion

The great economic and industrial transformations motivated the emerging of new schemes of value creation that distance more and more from the "productivist system" and in which the substitution of networks to the hierarchies is more than a management fashion. The emerging network organization can be positioned in this movement.

One of the central questions is that to know if this "new" morphology of organizations will substitute the big managerial integrated and hierarchizied firm. The answer to this question is not easy because several archetypes of network-organization exist. For example, Veltz (2000) considers that at least "six key-types" of network-organizations and that all of these forms could be combined.

Results show a reorientation of the world alcoholic beverages industry, characterized by a stronger concentration and specialization (Coelho and Sousa, 2000) and, also, an increasing quest for internal and external flexibility, typical of network organizations. Therefore, these various factors intensify competition among firms.

The slow emerging of network-organization in some zones of the world, like Continental and Southern Europe, could be explained by the less favourable cultural environment to this evolution. At the opposite, are positioned the Japanese MNEs in the food and beverages industry in which one could identify some key values like the team working and consensus. Hence, further research work should try to assess the "denaturing" process of organizational models, i.e. the converging pressures toward a unique "multicultural" model or the relative stability of national models.

Our approach has several limitations. First of all, the definition of "asset specificity" worth an in depth analysis. Boissin (1999) distinguishes between the "specific assets constructed" (creating and endogenous specificity) and the "pre-existing specific assets" (traditional view of transaction costs economics). Moreover, at a more analytical level the definition of what is a "network" contains several imperfections and thus should be refined. This is a consequence of the complexity and the variety of "intermediary" forms of governance but the same applies to the markets and hierarchies – the need of a more accurate typology of networks and of the environments in which they operate in function of the various combinations among the three modes of coordination is also an important key issue. Finally, the approach should take into account path dependencies and more particularly the life cycle phases of the industry and of each one of MNEs.

In a configuration in which the food and beverages MNEs tend to reinforce its dominant position (oligopoly), stroke by profound changing in the relationships between suppliers (industry) and customers (hypermarkets) and by the geo-strategies of MNEs in the whole food system, the future agenda for MNEs concerns the co-ordination of activities (identification of the "heads" of each network and the main processes) and the stabilization of each organization. In fact, optimizing the functioning of a network-organization requires not only the use of an effective technical device (hardware, software, common rules) but also minima of relational learning and of accumulation of shared knowledge. All of this needs time. When compared with other industries, the present restructuring trend in the food and beverages industry is relatively new and that is why one should expect that the emerging network-organization forms will take some time to be achieved, even if consumer pressures will accelerate the process (quality, traceability).

References

Contact the author for a list of references

End Notes

[1] However, in the case of major restructuring operations - when the assets or the market shares of the firms are too important - the intervention of the regulation authorities is justified. Thus, lately in the alcoholic beverages industry the divestiture of Seagram (Canada) led Pernod Ricard (France) and Diageo (Great-Britain) to get the approval of the Competition authorities of the European Union and from Canada and from the Federal and Trade Commission in the US.

[1] For each one of the 10 MNE selected we identified all the restructuring operations done by these firms during the period 1991-2000. Data was collected from annual reports, Lexis-Nexis database and other specialized publications. All the restructuring operations were classified following the nature of asset specificities.

Characteristics of South-North Investments and Its Implications

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Abstract

The country of origin and the stage of economic development play a major role in determining the characteristics of the multinational firms and their investments. This paper deals with the verification of characteristics of investments from developing countries of Asia and Latin America to the USA, industrially developed country and provides comparisons. Based on theoretical and empirical research the characteristics are expected to be different. The characteristics evaluated are average size of investment, capital intensity, level of exports from the USA, level of imports to the USA, profitability, extent of R&D in the U.S. , level of intra-firm trade, and the proportion of majority owned affiliates.

Introduction

This paper examines the characteristics of foreign-owned U.S. investments on the basis of Department of Commerce, BEA data. Based on the literature survey and the research questions hypotheses are formulated for analysis of the characteristics of FDI. Because of late industrialization and liberalization of their economies, the competitive advantages and characteristics ascribed to leading companies of developing countries are not same as developed countries and hence the characteristics of the developing country firms will tend to be different than those of developed and industrialized country firms. Due to industrial and structural differences between developing countries, the characteristics of developing Asian and Latin American country's outward Foreign Direct Investments (FDIs) are expected to exhibit different characteristics than those from other developing countries.

Characteristics of Developing Country Firms

In many ways Multinational Enterprises (MNEs) from newly industrialized countries are different from MNEs from industrialized nations. Our question is, are MNEs from Developing Countries (DCs) different from MNEs from Industrially Developed Countries (IDCs) countries and if so, how different? What characteristics enable DCMNEs to survive in the competition from IDCMNEs and from host country firms?

In the literature on the FDI from developing world, the important works of Kumar and McLeod [1981], Wells [1983] and Lall [1984] have studied the characteristics of Third World FDI. According to Lecraw [1981] and Monkkeiwicz [1986], Third World firms use small scale, more labor intensive and more flexible technology than MNEs from industrialized countries. They employ man rather than machine insertion of components in assembly lines. Their flexibility comes from switching labor from task to task and from product to product, and not from employing expensive multifunctional machinery as do MNEs. Third World MNEs depend more often on purchased production technology from abroad than on domestically developed technology. Their products contain a high proportion of components and parts bought from outside the organization.

It is argued that third DCMNEs' outputs are generally of a lower quality than that of other MNEs and compete in the low price end of the market [Wells, 1983]. Third World MNEs tend to export less of their output from their foreign subsidiaries. Their exports are more often to markets other than those in their home countries [Lecraw, 1992]. They tend to import a lower proportion of their inputs than do other MNEs, resulting in greater linkages with the host economies. Based on theoretical and empirical research as discussed above and in the chapter two on characteristics of FDI following propositions related to the characteristics of developing country firms in the USA are developed.

As a result of these characteristics, DCMNEs' market shares are usually small. They do not normally dominate a country's market, but they do dominate the low price end of the market, as Korean MNEs do in the UK and US personal computer markets.

Proposition 1: Because of structural differences in their home country economy, host economy and industrial differences, the characteristics of DC MNEs are likely to be different from those of MNEs from IDCs.

The rationale for country of ownership differences: Foreign investors are more likely to be active in industries with particular attributes, and, in a given host country, the characteristics of plants owned by investors from one foreign country tend to be different from those owned by investors from other foreign countries. The proposition is supported in general.

1.1 Size of the Investment

Proposition 1.1**:** The average size of MNEs from DCs is likely to be smaller than that of the IDCs.

The study of manufacturing establishments [Howenstine and Zelle, 1994 and Howenstine and Shannon 1996] suggests that the establishments of six industrialized countries and major investors in the US economy tend to be significantly larger than even the US owned establishments in the same industry. In the case of developing country firms we expect them to be of a smaller size than average industrialized investments due to structural differences in home country economy, development of markets and industry in home country. Table 1 confirms this proposition. The size of the firm is calculated by dividing the total investment by the number of firms. Asian average investments have increased from 50.24 million in 1992 to 80.35 million in 1997, and that is comparable to the Latin American average investment of 34.19 million in 1992 to 75.63 in 1997. But that still is much smaller than developed country investments of 161.04 million and 357.33 million in 1992 and 1997 respectively and hence the proposition is supported.

1.2 Capital intensity

Proposition 1.2**:** DC MNEs are likely to be less capital intensive than the MNEs from IDCs.

Due to labor surplus and labor-intensive manufacturing in the home countryDC MNEs are expected to be more labor intensive and less capital intensive. The verification of capital intensity by gross property to total assets suggests that developing countries are more capital intensive than the developed country firms. Capital intensity increased as ratio of gross property to total assets changed, from being 0.47 in 1992 to 0.60 in 1997. Compared to that the capital intensity of Latin American as well as other developed country investments decreased. For developed country firms ratio changed from .37 to .27 from 1992 to 1997 and is comparable to the capital intensity of all the foreign firms operating in USA.

1.3 Exports from USA

Proposition 1.3**:** DC MNEs are likely to record a lower export propensity than the MNEs from IDCs.

DC investments are market seeking investments. Based on assumption that DC investments are market seeking we expect DC MNEs to export less than the firms from IDC MNEs. Exports from developing countries as a percentage of total sales was 10.21 percent in 1992 and has increased since to 12.75 percent in 1997. Latin American firms exported 11.42 percent of its sales in 1992. In the case of developed countries, exports have been 8.92 percent in 1992 and have slightly decreased to 8.56 percent in 1997, matching the overall trend of decreasing exports as a percentage of sales. But the exports as a percent of sales of Asian exports were at 20.24 percent in 1992 and reduced to 17.22 percent that too is higher than the Latin American exports.

DC investments are market seeking as well as asset seeking. One of the major reasons for investing in IDC is to seek technical assets and hence it is likely that DC MNEs produce technology intensive products in IDC and export it to home country or near by regions. The proposition was rejected.

1.4 Imports to USA

Proposition 1.4: The import propensity of DC MNEs compared with IDC MNEs is likely to be higher.

As DC MNEs invest in USA to replace exports to USA, they are expected to import raw materials and labor intensive intermediate products from home country and/or near by countries with cheaper raw material and labor. The import propensity of DC MNEs compared to IDC MNEs is likely to be higher. Imports as a percentage of sales have been on he rise for all countries. DCs have a higher percentage of imports at 31.56 in 1992. Which has decreased to 27.06 percent in 1997. At the same time, developed countries' imports increased marginally less than a percentage point from 15.89 percent in 1992 to 16.28 in 1997. Latin American imports have been more or less leveled at 24 percent but this is much higher than developed country imports. The proposition is supported.

1.5 Profits

Proposition 1.5: The levels of profitability of DC MNEs are likely to be lower compared to IDC MNEs.

Due to lack of operational experience in the USA and related concerns, profitability of DC MNEs is likely to be lower compared to IDC MNEs operating in the USA. The verification of operating profits to sales suggests an increase in profits as a percentage of sales for both the groups, but the difference in the percentage of profits is remarkable. Developing countries have increased profits as a percentage of sales from 0.28 percent in 1992 to 1.33 percent in 1997. In comparison to that, operating profits as a percentage of sales for developed countries have increased from 1.74 percent in 1992 to 4.78 percent in 1997. The proposition is supported.

The verification of profits of Latin American and Asian developing country investments suggest that Latin American firms have increased their profits as a percentage of sales from 3.10 percent in 1992 to 3.71 percent in 1997. There have been negative profits in the case of Asian investments from developing countries, but that has decreased from –2.72 percent in 1992 to –1.63 percent in 1997.

The comparison as per Table 1 provides following observations:

1. The total (All countries) and the developed countries have reasonable dependence on their parents and affiliates for their overseas business. But in the case of developed countries,' exports to affiliates and to parent company has reduced from 60.25 percent in 1992 to 56.26 percent in 1997. In contrast, Asian developing countries' exports have increased from 47.46 percent in 1992 to 65.78 percent in 1997 as a percentage of the total exports.

2. The firms of the developing countries have somewhat more dependence in terms of imports, but the figures between the groups are comparable. Developing country imports have increased from 75.34 percent in 1992 to 78.71 percent in 1997. Developed country imports have increased from 78.91 percent to 79.52 percent, i.e. less than a percentage point.

Here the trend suggests that over the period of five years, these firms have had a remarkable increase in dependence on their parents group and affiliates for their imports from overseas.

3. The breakup of exports to sales and the imports to sales of the developed country firms is more or less constant over the period. However, though the exports as a percentage of sales are fluctuating, imports have increased less than a percentage point. Asian developing country exports as a percentage of sales have increased from 9.61 percent in 1992 to 11.32 percent in 1997 and imports as a percentage of sales have decreased from 24.90 percent in 1992 to 17.66 percent in 1997.

4. As is the case with overseas business, it is observed that the firms of developing countries depend more on their parents and affiliates for their overall supply/sales. Thus, observing the readings a trend/characteristic emerges which demarks the origin of the firm.

TABLE 1
CHARACTERISTICS OF THE INVESTMENTS FROM DEVELOPED vs DEVELOPING COUNTRIES

Characteristics	Variable		Total (All Countries)		Developed Countries		Asian Developing Countries		Latin American Countries		Source
			1997	1992	1997	1992	1997	1992	1997	1992	
1 Size of the Firm	Size(S)=Total Inv./No.of firms	$ Million	325.52	139.52	357.33	161.04	80.35	50.24	75.63	34.19	Tab j3
2 Capital Intensity	Gross Property/Total Assets		0.26	0.36	0.27	0.37	0.60	0.47	0.40	0.51	Tab j3
3 Exports	Exports/Sales	%	8.2	8.4	8.6	8.9	17.2	20.2	(D)	11.4	Tab h2 & e2
4 Imports	Imports/Sales	%	15.2	15.0	16.3	15.9	27.1	31.6	24.5	24.7	Tab h2 & e2
5 Profits	Operating Profit/Sales	%	4.6	1.7	4.8	1.7	-1.6	-2.7	3.7	3.1	Tab e2
6 R & D	R&D Exp/Sales	%	1.1	1.1	1.1	0.9	1.0	0.7	0.2	(D)	Tab j5 & e2
7 Intrafirm Trade											
	Affiliates & Parent Exp/Total Exp	%	54.1	56.4	56.3	60.2	65.8	47.5	(D)	38.8	Tab h2
	Affiliates & Parent Exp/Total Sales	%	4.4	4.8	4.8	5.4	11.3	9.6	(D)	4.4	Tab h2 & e2
	Affiliates & Parent Imp/Total Imp	%	79.8	78.0	79.5	78.9	82.0	78.9	72.2	75.8	Tab h2
	Affiliates & Parent Imp/Total Sales	%	12.2	11.7	12.9	12.5	22.2	24.9	17.7	18.7	Tab h2 & e2
						12.7		23.6		18.2	
8 Majority owned affiliates	Majority Affiliates/Total	%	85.19	86.18	85.23	86.20	84.93	86.06	86.52	87.69	Tab j3 & 2

Notes
1. Developed Countries include the EU + Japan while the Developing Countries include Asia Pacific & Latin American countries
2. Operating profit is arrived at by deducting the COGS and selling and admin expenses from the Sales.
3. Due to unavailability of R&D data on the Latin American companies for 1992, only Asia Pacific figures have been provided, and they are comparable, as it's a ratio.
4. For measuring the intrafirm trade, total quantum of Exim to and from Parent and Affiliates to the Total is taken
5. The mean of the number of affiliates is taken for the group of Developed and Developing Countries.
6. Created based on Department of Commerce, BEA Data.

1.6 Extent of R&D in the USA

Proposition 1.6: DC MNEs likely to be involved less in R&D related activities compared to MNEs from IDC.

DC MNEs do not have resources to undertake R&D activities and hence they are expected to be less involved in R&D activities compared to MNEs from IDCs. Significant differences exist between foreign firms from developed countries and developing countries, but in developing countries differences within the group also exist in terms of R&D: (1) establishment, (2) expenditure, (3) employment.

The level of R&D has been looked at from two angles, R&D expenses as a percentage of sales as per Table 1, and employment in R&D as a percentage of total employment in Table 2. The verification of level of R&D through both ways confirms our hypothesis that developing country firms are involved less in R&D related activities, i.e. they spend less on R&D as a percentage of sales and they employ less engineers and scientists as a percentage of total employment.

TABLE 2
R&D SCIENTISTS AND ENGINEERS EMPLOYED
(AS A PERCENTAGE OF TOTAL EMPLOYMENT)

	1980	1992	1995
All Countries	2.13	2.21	2.08
Japan	1.56	1.52	1.62
Asian Developing Countries	0.15	1.20	1.65
Group I			
Taiwan	na	3.00	1.05
Hong Kong	0.21	0.32	0.29
Singapore	na		4.00
Korea	na	2.06	4.37

Source: U.S. Dept of Commerce, BEA data

1.7 Intra-firm trade

Proposition 1.7**:** Intra-firm trade by DC MNEs is expected to be less than intra-firm trade by IDC MNEs.

The typical characteristics of global MNEs from IDC is that they have global networks of affiliates facilitating intra-firm trade. DC MNC lack the networks of affiliates and hence intra-firm trade by MNEs from DC is expected to be less than intra-firm trade by IDC MNEs. It is the endeavor here to check whether the intra-firm trade, taking place amongst the units under consideration is a point that differentiates the origin of the firm. As a measuring tool, the firm's business (import or export) with either its parent firm or the parent group together, with the affiliate firms across the international borders is taken. The export of the affiliate firm to its parent group together with its export to its foreign affiliates (either of the same lineage or association) is matched with the firms total exports as well as to the firms total sales to acquire an understanding of the export behavior of the firm.

The corresponding comparison for the imports from the related firms, parent or cross border affiliates, to the total imports and the sales is also taken. Imports are also compared to Sales (instead of cost of goods sold) to give us a sales break-down. This comparison is done for 1992 & 1997 to give us movement of the said characteristic in that time frame.

1.8 Majority owned affiliates

Proposition 1.8: The percentage of majority owned affiliates of the total number of firms is expected to be less for DCs than for IDCs.

Due to capital intensive nature of investment in the IDC, lack of experience and organizational capabilities the DC MNEs are expected to have less percent of majority owned affiliates. The overall trend suggests that the percentage of majority-owned affiliates are more than 80 percent and less than 88 percent for all the countries, and it has not changed much over a period of time although it has slightly decreased in all groups. For all the countries, majority-owned affiliates have changed from 86.18 percent of the total to 85.19 percent; for developed countries it has changed from 86.20 to 85.23. In the case of subsidiaries in the USA from Asian and Latin American developing countries, the percentage of majority owned affiliates has decreased from 86.52 to 84.93 and 87.69 to 86.52 percentage from 1992 to 1997.

2 Mode of Entry

Proposition 2.1: There are likely to be significant differences between foreign firms from Group I, Group II, Group III countries in terms of the proportion of each of the four types of direct investment they have used in the USA: (1) green field investment, building new factories, (2) acquiring existing firms, acquisition, (3) investing in existing firms with a portion of ownership, joint ventures and (4) establishing a brand new joint venture, alliances.

There are significant differences between international firms from developed country firms and developing countries. Within group differences exist in terms of: (1) their original amount of investment in the United States; (2) the percentage ownership; (3) their total gross investment; (4) years involved in their foreign direct investment in the United States; and (5) the percentage of their total investment spent in (a) building new factories, (b) acquiring existing firms in the U.S. and (c) establishing joint ventures[1]. The proposition is supported by evaluations from Table 3[2].

Different current theoretical considerations explain the reasons why firms from NICs and the DC firms expand via FDI and why they often share equity with local or other foreign partners in establishing overseas subsidiaries.

Proposition 2.2**:** DC entry investments tend to be through acquisitions or cooperative alliances, and prefer JV or local collaboration than through the green-field mode.

Above proposition is supported by the data analysis and Asian developing countries do use mergers and acquisitions as mode entry.

Conclusions

Earlier studies suggest that the pattern of FDI by TWMNEs is changing when evaluated in the context of present theories of TWMNEs and IDP. In this chapter, characteristics of investments from the developing world are studied in light of earlier discussed major theoretical strands that provide the explanation of the outward direct investments from the developing world.

In conclusion our findings suggest that characteristics of DC MNEs are different from IDC MNEs as hypothesized. The average size of investment is smaller. We expected DC firms to be less capital intensive but their investment in the USA seems to be more capital intensive. The export propensity of DC firms was expected to be lower, but this proposition was not supported. The probable reason could be that the DC MNEs are market seeking as well as asset seeking and asset seeking MNEs export their products to their home country or near by region. Import propensity of DC MNEs is higher, the level of profitability is lower, and they are less involved in R&D related activities. They are much dependent on their parent firms for imports and hence intra-firm trade is higher. The DCs have less percentage of majority owned affiliates to the total number of firms.

The difference in characteristics of South-North FDI implies that the OLI (Ownership, Locational and Internalization) advantages suggested by Dunning differ for the MNE's from the south. In view of the North American Economic Integration and increasing trend of mergers and acquisitions suggests that the complimentary nature of advantages lead to greater gains for cross border business partners.

TABLE 3
ENTRY MODE SELECTED BY FIRMS INVESTING IN THE US FROM 1989 to 1994

Type of Investment	TOTAL		DC Total		Latin America Total	China CH	Hong Kong HK	South Korea KS	Malaysia MY	Singapore SN	Taiwan TW	Asia Total		Developing Countries Total	
AM-Acquisition and Merger	1860	42.0%	1482	41.1%	48.7%	13	31	18	11	15	21	109	52.7%	128	52.0%
JV-Joint Venture	351	7.9%	297	8.2%	7.7%	3	3	4	*	1	1	12	5.8%	15	6.1%
NP- New Plant	438	9.9%	402	11.2%	7.7%	1	1	4	*	*	6	12	5.8%	15	6.1%
OT-Other	1049	23.7%	828	23.0%	20.5%	9	1	29	*	2	*	41	19.8%	49	19.9%
PE- Plant Expansion	342	7.7%	312	8.7%	2.6%	*	*	4	*	*	3	7	3.4%	8	3.3%
Real Estate	179	4.0%	115	3.2%	12.8%	1	9	1	1	2	8	22	10.6%	27	11.0%
E I - Equity Increase	210	4.7%	166	4.6%	0.0%	1	1	1	*	1	*	4	1.9%	4	1.6%
Total	4432	100.0%	3605	100.0%	100.0%	28	46	61	12	21	39	207	100.0%	246	100.0%
Percentage of Total						0.6%	1.0%	1.4%	0.3%	0.5%	0.9%	4.7%		5.6%	

Developed countries include Belgium, Canada, England, France, the Netherlands, Sweden and Switzerland
Latin America includes firms from Argentina, Brazil and Mexico.
Table based on DOC, BEA data.

End Notes

1. Explanations and definitions of entry modes are based on the Department of Commerce description: An acquisition is a transaction in which title to stock or assets of the U.S. entity is secured by another person or enterprise. The substantive result is that one party obtains ownership of another. An equity increase is a gain in percentage of equity securities held, or an equivalent gain in the percentage of ownership, by a foreign investor. A joint venture is a transaction in which two or more parties establish a new business enterprise to which each contributes, and in which ownership and control is shared. A merger is a transaction which results in the dissolution of the acquired business enterprise, into either another already existing or into a reorganized (but not always renamed) company. A new plant is a new operating facility, established either in conjunction with an existing foreign-owned productive enterprise or as a completely new venture. The other entry mode includes new companies, headquarters, subsidiaries, branches, agencies, representative offices, stores, outlets, warehouses, and unidentified transactions. A plant expansion is an addition to the production capacity of an existing foreign-owned operating facility. Real Estate includes real property, excluding agricultural land and individual residential units for personal use.
2. Entry mode data is taken from Department of Commerce transaction data for the years 1989 to 1994; data for later years is not published and not available from the Department of Commerce.

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FDI, International Financial & Capital Markets

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Abstract

Considering the present and future scene, the financial activity is organized in large measure by Multinational Corporations. Their pre-eminence in world output, financial markets, trade, investment and technology transfer is unprecedented. In the 90´s the international movements of capital and several financial crises on international scale have taken place. Even when Multinational Corporations have a clear national base, their interest is in global profitability above all for the economies of the underdeveloped countries. The International Community has adopted political destined to attract foreign capitals. Multinational Corporations have grown from national firms to global concerns using Foreign Direct Investment to exploit their competitive advantages. Increasingly, however, they are using joint ventures, legal security to investors and strategic alliances-multilateral and bilateral agreements of protection and promotion of investments have subscribed- to develop and exploit those advantages or to share the costs of technological innovation. But the growing global financial market of production is not limited to Multinational Corporation activity, for over the last three decades there has been a significant growth in producer-driven and buyer-driven global production and distribution networks. The globalization of Foreign Direct Investment-business- is thus no longer confined to the Multinational Corporation but also embraces small and medium sized enterprises.

Firms engage in Foreign Direct Investment because they possess a specific competitive advantage that is best exploited in this way. The advantage may be a patented product or technique, but may also include management techniques and intangible assets in the skills and expertise of the firm of its personnel. But even so, firms do not have to produce abroad even with such advantages: Foreign Direct Investment markets can be served by exports or by licensing the technology to overseas producers; or the production process can be subcontracted to independent companies, possibly licensed to use the firms technology. However, the development of global financial networks necessarily involves the strategic organization of transnational transactions within the firm or among groups of firms rather than trough the market mechanism. The Direct Foreign Investment at the moment constitute more important volatile part of the dependent and interdependent components of the capital flows towards underdeveloped economies in the world. Although financial globalization is often understood simply as the spread of global markets, the growth of Foreign Direct Investment and global production networks represents something rather: the growing transnational organization of production and distribution within and among firms instead of through markets. International markets are not, therefore, perfect: if they were, Multinational Corporations and global production networks would not exist. As a consequence the costs of doing business for Multinational Corporations are significantly lower if they organize economic activity within the firm, or through networks of firms, rather then through market relationship.

Multinational Corporations, however, are the linchpins of the contemporary world economy. Despite regional concentrations of production, transnational business networks span the three core regions of the world economy, linking the fortunes of disparate communities and Nation-States in complex webs of interconnectedness (national firms with international operations). The Foreign Direct Investment play a much more central role in the operation of the world economy than in the past and they figure prominently in organizing extensive and intensive trasnational networks of coordinated production and distribution that are historically unique. Foreign Direct Investment and global production networks are critical to the organization, location and distribution of productive power in the contemporary world economy. This is reflected too in shifting patterns of global speculative markets of capital and migration of people on the move.

Finally, to be able to construct an efficient financial system, it is possible to mention that these measures-regulation of the international movements of capital- are possible with a good supervision and regulation of all international system.

Introduction

Foreign investment is one of the primary engines of development worldwide. Indeed, for those countries with low domestic rates of savings, and poor access to international credit, foreign investment is one of the only vehicles for development of any kind.

Neo-liberal globalization is a process that began in the 1980s with deregulation and trade liberalization. Globalization is a complex phenomenon that covers three dimensions: the international mobility of goods and services, the mobility of productive capacities through FDI, and the mobility of financial capital. Neo-liberal globalization involves a new regime of accumulation, with financial domination [2], which has increased the financial fragility of both internal financial systems and the international monetary and financial system. Capital markets become more prominent than banking credit in financing enterprises.

This new regime of accumulation radically changes the way corporations are managed. These large companies follow a fundamentally financial logic. Their profitability and the incomes derived from stock options do not depend so much on the productive and internal strength of the firm, but on its increased value on the stock market. Mergers and acquisitions, that were popular over the last decade, were decided not only on the basis of productive or trade potential, but more importantly on their repercussions on market share value. These mergers were a powerful lever that propelled stock market boom of the 1990s. I will begin with the hypothesis that changes to the productive systems of Capital Markets and International Direct Investment, in addition to the structure, composition, and geopolitical orientation of foreign trade flows; have been determined fundamentally by the movement of foreign capital.

This project examines whether policies to promote Foreign Direct Investment (FDI) make economic sense. The discussion focuses on whether existing academic research suggests that the benefits of FDI are sufficient to justify the kind of policy interventions seen in practice. For open economies, efficient taxation of foreign and domestic capital depends on their relative mobility. Also the role of business and capital markets networks in international financial by the Foreign Direct Investment (FDI) in the world economy. This study finds a significant positive role in inward FDI of networks by world investment system.

FDI, Financial Markets & Entrepreneurship: FDI, International Financial & Capital Markets

Since the trade liberalization of both countries, and mainly since the signing of the free agreement trade, the strategies of the primary transnational corporations were as follows Global corporations that follow a global logic focused on the world market and international market, combining this with the restructuring of internal private groups in the world system in order to adapt themselves to globalization process determine changes in asset ownership, the sector and geopolitical location of investment and the geo-strategies destination of produced goods, I mean, foreign market vs. domestic market is like to say FDI vs. world market. Foreign Direct Investment (FDI) has, in this way, contributed to strengthening transnational regions around the world.

Profound changes have taken place in the area of international direct investments and technology transfers over the past two decades. Foreign Direct Investment has emerged as the most important source of international resource transfers to developing countries since the mid-1980s. The trend of rising importance of arm's length licensing as an alternative channel of technology transfer has also been reversed since the middle of 1980s. Japan, for example, has emerged as an important source of FDI in this period as Japanese corporations were forced to move production abroad in order to stay competitive in the face of rising wages and appreciating yen since 1985. [3]

Nevertheless, the trend of rapid rise in magnitude of FDI inflows in developing countries tends to be a cause of optimism among them of prospects of receiving greater volumes of FDI inflows and associated multiple benefits such as technology transfer, market access and organizational skills as FDI is perceived to be transfer of a package of capital and these resources. The recent growth in magnitudes of FDI inflows to developing countries has, however, benefited only a few countries. The least developed countries continue to receive a negligible share of FDI inflows despite liberalization of policies.

The North America Free Trade Agreement (NAFTA) is a good example of this kind of integration, as it has been the main field of experimentation for Neo-liberal globalization, whose operating rules are established by US financial capital with the support of dominating groups and the Canadian and Mexican governments. In the trade agreement between Canada and the United States, and subsequently, NAFTA, a series of rules were approved for foreign investors granting unlimited freedom, as well as a series of privileges. For the United States, the trading area of North America is transcendent, not only in outlining the rules of future continental integration in the context of the Free Trade Area of the Americas, but also in the size of its investments, as well as its trade in Canada and Mexico. 13 percent of US direct investment is in these two countries and a total of 65 percent of its investments in the American continent. [4]

These rules allow the signatory nations to keep a Neo-liberal course of trade liberalization and eliminate all restrictions of foreign capital operations. Their application greatly limits the possibility of establishing an active and independent industrial policy or to protect determined sectors and economic activity. Since the 1980s, both Canada and Mexico have abandoned their former nationalist and regulatory foreign investment policies. Intellectual property rights, although attempt to guarantee the protection of innovation and fight piracy, are an obstacle that conserve the advantages enjoyed by oligopolies. This triggers high prices and incredible profits for transnational corporations.

Furthermore, Foreign Direct Investment inflows also vary greatly in terms of bringing associated benefits such as technology and market access. All FDI inflows do not benefit their host countries in the same manner. Some FDI inflows in high technology sectors or those of export-oriented type may benefit their host countries more than those in soft technology consumer goods sectors oriented to local markets. Therefore, the quality of FDI inflows may vary widely. The high quality FDI inflows which can directly contribute to improved competitiveness of developing countries are even more unevenly distributed across countries.

Foreign Direct Investment (FDI) has become an increasingly important factor in the global economy, but much less research has been undertaken on the causes, consequences, and policy implications of FDI than on international trade. This network has redressed the balance through a programme of research and training, bringing together eight leading institutions from seven EU countries. It has extended the analysis of Multinational Corporations (MNCs), examined the economic impact of MNCs and FDI on the home and the host countries, and explored both national and international policy implications. The starting point has been research on the determinants of multinational activity at the level of the firm, and on the relationship between foreign trade and multinational activity.

By other way, if foreign and domestic capital is equally mobile internationally, it will be optimal for countries to subject both types of capital to equal tax treatment. If foreign capital is more mobile internationally, it will be optimal to have lower taxes on capital owned by foreign residents than on capital owned by domestic residents. Absent market failure, there is no justification for favouring FDI over foreign portfolio investment. In practice, countries appear to tax income from foreign capital at rates lower than those for domestic capital and to subject different forms of foreign investment to very different tax treatment. FDI appears to be sensitive to host country characteristics. Higher taxes deter foreign investment, while a more educated work force and larger goods markets attract FDI. There is also some evidence that multinationals tend to agglomerate in a manner consistent with location specific externalities. There is weak evidence that FDI generates positive spillovers for host economies. [5]

While multinationals are attracted to high-productivity countries, and to high-productivity industries within these countries, there is little evidence at the firm or plant level that FDI raises the productivity of domestic enterprises. Indeed, it appears that plants in industries with a larger multinational presence tend to enjoy lower rates of productivity growth over time. Research thus provides little support for the idea that promoting FDI is warranted on welfare grounds. Subsidies to FDI are more likely to be warranted where multinationals are intensive in the use of elastically supplied factors, where the arrival of multinationals to a market does not lower the market share of domestic firms, and where FDI generates strong positive productivity spillovers for domestic agents.

By this way, the liberalization of emerging financial markets and increasing global financial integration over the last two decades have set the stage for a new, frightening kind of implosion, where a nation's currency and banks both collapse, leading to capital flight, soaring interest rates and a depreciation of the real economy. For example, since then, Russia, Mexico, Thailand, Indonesia, Malaysia and other nations have faced economic disaster when a currency crisis combines with a banking collapse.

Besides a formal devaluation, factors such as actual or rumored political instability, interest rate hikes, a spectacular company failure or unexpected declines in the economy can all lead anxious investors to move their money elsewhere. As this happens, people sell more of the local currency, flooding the market and further reducing its value. To maintain the peg, the government needs to raise the value of the currency, usually by selling its reserves of foreign currency and buying its own. When it becomes obvious that the government has insufficient reserves-or willpower-to meet its obligations to finance imports, debt and still support its currency, that triggers a currency crisis. When this occurs, governments, banks and companies that have taken out debt denominated in dollars, marks or other strong currency, but whose income is in the local currency face danger as debt becomes increasingly unmanageable: it takes more and more local currency to meet payment schedules. At the same time, real interest rates tend to rise after a currency crises to make up for risk of increases in future inflation to levels of 20% to 50%-levels that are generally considered unsustainable.[6]

However the arguments for capital account liberalization and against financial capital markets can be summarized thus; the first, flows of foreign capital into a country can help improve productivity and this, in turn, brings about a major increase in living standards. It also promotes integration of economies into the world financial system; the increased availability of capital and diversity of its source is good for growth. Second factor, open capital accounts promote good policies: countries which have stable governments, fair and consistent regulations, and attractive investment climates will attract more funds. Capital market liberalization provides both a carrot and a stick; countries that pursue such policies will find that they can attract more capital; those that do not will find capital rapidly leaving.

Third factor, capital markets are micro-economically inefficient in that they hinder the optimal allocation of resources, money isn’t allowed to naturally flow to the most efficient or successful companies, or investments. Control markets also have large administrative costs, are widely evaded, and give rise to corruption. But the downside of the process proved to be painful, and a series of global financial crises beginning in the late 1990s helped to start the reversal in the trend of rapid capital market liberalization.

The heavy inflow of capital into developing countries that liberalized their capital accounts had pushed the value of those countries currencies upwards against the United States (U.S.) dollar or euros. But when foreign investors lost confidence in the economies of these countries, they began to pull their money out. The value of the currencies then fell sharply against the U.S. dollar, making it ever more difficult for the developing countries to pay back their debts and causing foreign investors to lose even more confidence. The years after capital market liberalization spread were punctuated by a series of financial crises, including the Asian crisis in 1997, the Russian crisis in 1998, the Brazilian crisis in 1999, the crises in Turkey and Argentina in 2001. Over a hundred countries have faced crises in the past 30 years. While a number of different factors have contributed to each, capital market liberalization has usually been an important factor: Most of the crises have been precipitated by the rapid flow of money out of the country, and in some cases, such as Thailand, the country’s problems prior to the crisis had been exacerbated by rapid flows of money into the country.

In 1997 the Asian crisis began when foreign exchange speculators began selling off Asian currencies. The countries were stuck in a tight place. The way to stop money going out of a country is to raise interest rates, but developing countries found that raising interest rates was terrible for their banking sector. Higher interest rates mean that people and companies who have borrowed money find it harder to pay it back. When they stop repaying, banks go out of business and stop lending. Less developed countries don’t have strong stock markets and so rely far more on bank finance to grow the economy and create jobs. Bank closures can mean the economy stops growing. After currencies collapsed in Thailand, South Korea and Indonesia, so did their banking systems. As things got worse, commercial banks with long-term relations with many of the affected countries also reduced their credit lines. The end result was massive bankruptcies and an increase in unemployment. Ultimately some 12%-15% of Gross Domestic Product left these countries [7]as capital flowed out. Thailand, South Korea, and Indonesia did not have perfect economies and there were problems with some of their companies and banks, including shaky lending practices; over investment in bubble assets, such as real estate; lack of regulation and oversight-all of which contributed to the weakness in the region's banks. But despite these flaws, the crisis itself was triggered by the massive outflows of capital.

A separate problem concerns liquidity, or having enough access to cash when it is needed. Liquidity shortages typically occur as a result of one of two interrelated factors. The first has to do with the sudden cessation of capital inflows, which means that companies so far reliant on foreign flows for their financial survival now find it difficult to refinance their debt. The second factor has to do with the Central Bank, which, while trying to defend a currency peg, drains liquidity from the local system. By doing so, it can cause real sectors of the economy to contract, and even induce banking failures. Ironically, it is the strongest and most promising countries (for example Mexico in 1994 and East Asian nations in 1997) that are often subject to liquidity cris es. As the ones that attract the strongest capital inflows, these countries are sometimes likely to over borrow and are thus most affected by capital flight when things start financial crises.

Much depends, as noted above, on the currency in which revenues and debts are denominated and if there is currency mismatch, for example when revenues are in the local currency and debt is in hard currency. It also matters whether the private sector is exposed to risks from changing interest rates. Britain's sudden exit from the European Monetary System in 1992, accompanied by a sudden devaluation of sterling against other countries, seemed like a national humiliation at the time[8]. But, the domestic economy in retrospect, appears to have benefited from the sudden imp rovement in competitiveness and lower interest rates leading to an impressive economic recovery. While the devaluation of the Mexican peso in 1994 led to more than 50 per cent of the nation's bank loans being written off, the healthier Brazilian banks survived with no greater write-offs than usual after the Brazilian real was devalued in 1999. It is like to cite four prerequisites for financial collapse: a)Financial liberalization; b) a fixed currency value; c) large capital inflows; d) underlying weakness in banks and firms.[9]

Of course, any one of these factors can start the vicious cycle, but all must be present for a currency crisis to cause an economic disaster. For that situation the currencies lose value when the inflation means the currency buys less real goods and services within a nation. Measures the rate that prices increase. Inflation and Exchange Rate Depreciation are closely related over the long term, but can vary widely over the short term. For example, if a country expands the money supply faster than the economy itself is growing, the currency would be worth less both inside and outside the nation, causing both inflation and a devaluation. Exchange rates take into account not only current inflation, but anticipated increases. Devaluation can also lead to inflation by forcing up the price which locals must pay for imported goods.

However, the critics of rapid capital account liberalization market say, there is a difference between Foreign Direct Investment (FDI), (that is, investment in factories, businesses, and things that produce goods and services) and portfolio investment in stocks and bonds, which tends to be more speculative. FDI is money that is sunk into ownership of companies and property that can not be pulled out of a country overnight. Early supporters of capital account liberalization did not really think about the differences between these two kinds of capital flows, but now while pretty much everyone agrees that FDI is important, they worry about unregulated portfolio investment and the effect it has on developing countries.[10]

The FDI is a significant source of development finance for all its potential, there is far greater awareness of the complex nature of FDI and the possible negative impacts of rapid and large growth for least developed countries. A crucial question is how FDI might be better applied to support more sustainable forms of development, particularly in those countries with burgeoning debts and widening income disparity to the rest of the world. Attraction of FDI is becoming increasingly important for developing countries. However this is often based on the implicit assumption that greater inflows of FDI will bring certain benefits to the country's economy. FDI, like to Official Development Aid (ODA) or any other flow of capital, is simply that, a source of capital. However the impact of FDI is dependant on what form it takes.

With a stimulation of national economy, Foreign Direct Investment (FDI) is thought to bring certain benefits to national economies. It can contribute to Gross Domestic Product (GDP), Gross Fixed Capital Formation (total investment in a host economy) and balance of payments. There have been support indicating a positive link between higher GDP and FDI inflows, however the link does not hold for all regions over the last ten years FDI has increased in Central Europe whilst GDP has dropped. FDI can also contribute toward debt servicing repayments, stimulate export markets and produce foreign exchange revenue. Subsidiaries of Trans-National Corporations

(TNCs), which bring the vast portion of FDI, are estimated to produce around a third of total global exports. However, levels of FDI do not necessarily give any indication of the domestic gain. Corporate strategies protective tariffs and transfer pricing can reduce the level of corporate tax received by host governments[10-2].

Also, importation of intermediate goods, management fees, royalties, profit repatriation, capital flight and interest repayments on loans can limit the economic gain to host economy. Therefore the impact of FDI will largely depend on the conditions of the host economy, the level of domestic investment/savings, the mode of entry and the sector involved, as well as a country's ability to regulate foreign investment. By this way, the stability of FDI inflows can be less affected by change in national exchange rates as compared to other private sources (portfolio investments or loans). This is partly because currency devaluation means a drop in the relative cost of production and assets (capital, goods and services) for foreign companies and thereby increases the relative attraction of a host country. FDI can stimulate product diversification through investments into new businesses, so reducing market reliance on a limited number of sectors or products.

However, if international flows of trade and investment fall globally and for lengthy periods, then stability is less certain. New inflows of FDI are especially affected by these global trends, because it is harder for a foreign company to de-invest or reverse from foreign affiliates as compared to portfolio investment. Companies are therefore more likely to be careful to ensure they will accrue benefits before making any new investments. Examples of regional stability are mixed, whilst FDI growth continued in some Asian countries, Korea and Thailand, during the 1996/97 crisis. During Latin America's financial crisis in the 90's many Latin American countries experienced a sharp fall in FDI, suggesting that investment sensitivity varies according to a country's particular circumstances. Many advocates of capital market liberalization claim that without capital market liberalization, countries will not be able to attract foreign direct investment but there is little evidence to support that conclusion. China, for example, is the largest FDI recipient in the world and has a closed capital account (The Chinese government has made verbal commitments to liberalize, but few measures have yet been taken).[11]

Nevertheless, free capital mobility makes macro-economic management difficult, in good times, as well as bad. In good times, the rush of money into a country can lead to an overvalued exchange rate. That swells the country's liquidity which, in turn, fuels inflation. To avoid inflation, countries often raise interest rates, but this simply makes matters worse, as more capital is attracted into the country. While many countries have had problems implementing capital controls, some have done so with remarkable success, such as Latin and Asian countries.

Changes in technology have exacerbated the increase in volatility associated with capital market liberalization. When capital movements were first liberalized, foreign exchange trading was far less developed and communications were slower, so it was hard to imagine that it would be possible for speculators and banks to take hundreds of millions of dollars out of a country overnight. The situation over FDI, capital markets has remained highly contentious, but even mainstream economists have began to say that capital market liberalization should be done slowly and only after certain conditions had been met such as: the first development of a strong banking sector that is able to handle large inflows and channel them into productive investments.

Second factor, a restructured and efficient corporate sector that can use inflows effectively and not throw good money after bad. The third, a strong regulatory and legal regime that restricts monopolistic practices, ensures prudential banking practices, and, when needed, regulates bankruptcy of debt-burdened corporations. Fourth, a sound macroeconomic environment that avoids large fiscal deficits, which exacerbates the overheating associated with capital inflows, and inflexible exchange rate regimes, which can not handle the volatility of capital flows. Fifth factor, a strong system of prudential regulation, and laws that mandate proper accounting, auditing, and reporting. Finally, no implicit government guarantees that encourage excessive inflows of short term capital.

Without forgetting that, it is necessary to consider, the Cross-Border capital flows generally take one of three basic forms, Official Development Aid (ODA), debt, or equity investments. Therefore, Foreign Direct Investment is defined as any equity holding across national borders that provides the owner substantial control over the entity. This is generally defined as a 10% holding or greater. Most foreign direct investment ends up being 100% ownership by a Multi-National Corporation (MNC), though certain countries like to promote joint ventures with local entities. Cross-border investments providing less than 10% ownership of a foreign entity are referred to as portfolio equity investment.[12]

Likewise, there are two fundamentally different types of FDI, sometimes called modes of entry. The MNC can either buy an existing foreign company, or it can create a new company. The latter is often referred to as build vs. buy. Investment can create additional productive capacity in a country, but it may also create new competition for existing local companies. The important distinction is the difference between the FDI inflow and FDI stock. Inflow measures the amount of FDI entering a country during a given period. The FDI stock is the total amount of productive capacity owned by foreigners. FDI stock grows over time, and is defined to include all retained earnings of foreign-owned firms, which can be held in cash and or investments by the company.

The majority of FDI does go to the developed economies (Japanese automakers opening plants in the US and UK), but FDI to developing countries is still large and has increased substantially. Inward FDI to developing countries increased from $8.4 billion in 1980 to $37.6 billion in 1990, to $204.8 billion in 2001. This growth across regions masks the high concentration of FDI to developing nations. In 2001, about 62% of inward FDI to developing countries went to five countries: China, Mexico, Brazil, Hong Kong, and Poland. Least developed economies, including many in Africa, continue to receive very little FDI.[13] These tend to be shunned by MNCs, which prefer to invest in countries known to be safe, with relatively high levels of political stability, infrastructure, education, well enforced property rights, etc. The factors contributing to the growth of FDI starting in the early nineties a number of factors converged to make FDI increase dramatically. The first is the increased perception of risk associated with cross-border debt. The Latin American debt crisis in the 80's and the Asian capital crisis in 1997-1998 made lenders much less eager to lend across borders.

Perhaps the most important factor contributing to the growth of FDI since the late 1990s has been globalization, or the internationalization of production and the introduction of the so called global supply chain by MNCs. Technological change, especially lower transportation and communication costs, has enabled MNCs to locate specific stages of production in different locations, taking advantage of favorable local conditions to minimize costs and improve sales. Another substantial contribution to the growth of FDI has been change in government policy, as countries have begun actively courting investment from overseas. Many countries have changed policies to allow investments that earlier might have been prohibited or been otherwise difficult.

For what, the advantages of Foreign Direct Investment to help evaluate the merits of particular investments, or a particular country's inward FDI portfolio, look for some of the key benefits of FDI to a developing country that are listed here. The first can contribute to growth, higher incomes, and reduced poverty - perhaps the most it could hope for any economic activity in a developing country is that it contributes to economic growth. This is the heart of the matter, but as with many economic phenomena, there is not conclusive evidence here one way or another. But the empirical evidence is good that FDI often, though definitely not always, contributes to economic growth. To the extent that FDI contributes to economic growth, the evidence is indeed good than economic growth usually leads to reduced poverty, though not necessarily to a more equitable distribution of income.

Likewise, the second point, incentive structure leads to productive investment because Foreign Direct Investment is generally done by Multi-National Corporations; those companies are usually concerned with making investments that will create profits. Therefore, the investments are usually well-targeted towards setting up a business that will make money and create jobs. This contrasts especially with aid and loans to governments, which have often been squandered through corruption or spent inefficiently on unneeded infrastructure or other vanity projects.

Nevertheless, in third place, less volatile than other capital flows -because FDI is generally spent on hard assets such as plant and equipment, the capital embodied in FDI cannot flee a country in times of crisis as easily as debt capital. A company can not sell off a factory and pull out of the country as quickly as a bank can sell off the country’s bonds, or refuse to roll over short term loans. Even in instances where the FDI is in a service-related industry such as banking or advertising, substantial effort and time is spent to develop an ongoing business, and owners will not easily pull the plug. Thus FDI is said to be much less likely than debt capital to exacerbate a crisis situation, as happened in the Asian crisis in the late 90's. Experience through the nineties showed FDI to be much less variable than debt flows.

In consideration, fourth point, can lead to increased tax revenues -a successful foreign-owned firm should generate profits, and hence generate tax revenue for the host country. Those taxes can then be spent on needed infrastructure, social programs, education, etc. This is a strong incentive for government encouragement of FDI.

However, in some cases the tax benefits can be disappointing. One risk is that the government may provide too great a tax amnesty as an incentive. Also, if the foreign-owned entity produces an intermediate good purchased by its parent company, such as car parts that are shipped to an assembly plant in another country, then profits can be affected by transfer price manipulation. That is what happens when the subsidiary sells its product at an artificially cheap price to the parent company, so that it can pay lower taxes.

The fifth, can lead to technology transfer and management skills transfer - these are components of positive spillover, or the positive effect on local firms that is often cited as a key advantage of FDI. Because MNCs typically have greater technological and management expertise than local firms, such expertise can be transferred to other parts of the economy. This appears to happen most clearly when the MNC has close ties to local partners, suppliers and customers. But even in cases where the MNC is not tightly integrated with local firms, there is evidence that technology and skill transfer takes place, most likely through labor mobility, professional contacts, or a general raising of competitive pressure.

In this way, in sixth place, can improve skill and wages of labor force, FDI is often encouraged because MNCs are thought to provide training and better employment opportunities for development of the labor force. Evidence is strong that MNCs pay better and train employees more thoroughly than domestic firms in developing economies. It is also claimed that the presence of MNCs in the labor market provides incentive to local firms to improve conditions and wages of workers. However, that from the perspective of local firms this can be a negative if MNCs skim the local workforce of skilled workers, labor costs for local firms can increase.

Next point, may improve access to export markets, Multi National Corporations almost by definition require substantial skill in importing and exporting. Many economists and policy makers believe that a key benefit of FDI is that the presence of export oriented foreign firms in a country can help improve efforts by local firms to sell overseas. There is good evidence that this is the case. One way this happens is through improvements in shipping and logistics infrastructure increased presence of international shipping firms. There is probably also some knowledge transfer, where managers of local firms learn from the example of the MNC how to open new export markets.

However, the eighth, can provide additional demand for output of local producers - another key component of positive spillover is the increased demand for inputs from local suppliers that a new MNC can create, which can lead to increased revenue and profits for local firms. Some studies have suggested that a key determinant of the benefits to national income from FDI is the extent to which the foreign enterprise sources locally, rather than importing its inputs. Ninth, can provide lower-cost inputs for local suppliers - Similar to the previous benefit, if the MNC creates a product previously imported by local producers or otherwise in short supply, the FDI can lead to a decrease in production costs for local firms and correspondingly higher productivity and profits.

Finally, can improve the balance of payments and capital account - because exports will typically bring in hard currency, an export-oriented foreign-owned entity can improve the balance of payments and capital account of a nation. This balance of payment benefit is reduced, however, by the extent to which the firm imports its production inputs. In addition, the initial FDI investment itself can also be an important source of hard currency, since the MNCs will typically need to convert hard currency to the local currency to either purchase a local entity or contract for work and equipment in setting up a new entity. Note also that MNCs will eventually repatriate profits and retained earnings periodically, which causes a reduction in hard currency reserves.

Nevertheless, we need to consider, the social development in FDI, where it generates and expands businesses, can help stimulate employment, raise wages and replace declining market sectors. However, the benefits may only be felt by small portion of the population, where employment and training is given to more educated, typically wealthy elites or there is an urban emphasis, wage differentials or dual economies between income groups will be exacerbated. Cultural and social impacts may occur with investment directed at non-traditional goods. For example, if financial resources are diverted away from food and subsistence production towards more sophisticated products and encouraging a culture of consumerism can also have negative environmental impacts. Within local economies, small scale and rural businesses of FDI host countries there is less capacity to attract foreign investment and bank credit or loans, and as a result certain domestic businesses may either be forced out of business or to use more informal sources of finance.[14]

Despite, the risks of Foreign Direct Investment exist if foreign ownership becomes too extensive, decapitalization can occur as foreign owned firms become established and profitable, they begin to repatriate earnings to the home country of the owner. In so doing, local currency is converted to the home country currency, and capital leaves the country. If the base of foreign owned companies is large enough, this can lead to a serious capital drain. This is especially a concern if in times of crisis foreign-owned companies repatriate retained earnings suddenly. The effect of this can be similar to the effect of foreign lenders refusing to roll over short term loans - the country can be starved of capital, and a bad economic situation can be made dramatically worse. This is sometimes cited as one of the primary risks of a country becoming too reliant on FDI.

If FDI is to take a greater role in building developing country economies, further assessment of the factors which influence and are influenced by FDI flows is necessary. Foreign companies are thought to be attracted to recipient countries for a whole range of factors, political stability, market potential and accessibility, repatriation of profits, infrastructure of currency conversion. Privatisation and deregulation of markets are seen as central means to attract FDI, however this can leave the poorest or most indebted countries open to destabilising market speculation. National legislation can support better investment security for local markets, fair competition and corporate responsibility through defining equitable, secure, non-discriminatory, transparent investment practices. Whilst there is concern that increased regulation could detect new foreign investors, there is evidence, such as in Eastern Europe, that tighter regulation of corporate, environmental and labour standards has not affected FDI growth.[15]

Where low income and developing economies are successful in attracting FDI, they require considerable support to ensure that they can adapt to rapid and large inflows of FDI, and that these flows positively benefit domestic economic stability. This means developing strategies which encourage greater and longer term domestic investment and saving, as well as higher returns on investment capital. The development of an international multi-lateral rule based trading and investment system has been advocated widely. However, whilst the abandoned Multilateral Agreement on Investment would have provided greater rights for companies and investors, it gave limited support for the social, economic and environmental concerns of host countries. Furthermore, regulation of investment is only as effective as a country's ability to enforce it. The cost of implementation may be prohibitive for many countries, bilateral and multilateral support, along side multi-stakeholder participation, is vital for the formulation of such agreements.

The FDI can be better targeted toward the advancement of developing and heavily indebted countries, whilst ensuring the global security of coming generations. Consider the mobilise domestic resources, intemational private financial flows, international financial cooperation, trade, debt, new financial mechanisms and governance, in the context of increasing globalization, as well as the use of economic instruments and incentives to support long term private investment. And it is a crucial opportunity to take a closer look at institutional processes and the linkages between Foreign Direct Investment, trade and financial mechanisms, so that all of these can be better targeted toward meeting sustainable development targets. However, it will need to provide a good opportunity to create their implications making for a more economic sustainable future.

Conclusion

Today, generally agree that rapid liberalization of capital markets can be dangerous for developing countries unless they have strong banking sectors and developed ways of overseeing the financial sector.

The idea of controls on short term borrowing has also economy increasingly accepted, even if the idea of imposing controls during a crisis is still controversial. However, it is unlikely that the past trend of liberalization will be reversed. Countries that have liberalized will find it difficult to go back to the old system, but it seems likely that countries that have not fully liberalized will not rush to do so.

The new technologies, managerial practices and financing techniques of business operations have considerably changed the environment and decision-making process for international investment. At the same time, larger FDI flows also create new challenges to policy makers in host countries, in particular to preserve the capacity to pursue- in a non-protectionist and non-discriminatory way its own social and environmental objectives.

As a first conclusion, it should be repeated that external foreign investment is one of the fundamental elements in the development of the region. For it to be properly assessed various crucial factors must be taken into account, such as its form, amount, influence on the productive system and the effective contribution made to the investment. Its influence does not only concern the effective functioning of the economy but also transcends it and affects both the economic power and the political power structures. It is not merely a commercial problem or even a production problem. Rather, it transcends and defines the basic lines of economic development, which in turn, transcend political considerations. A parallelism may be drawn between investments that predominate in the basic economic sectors and hegemonic political power. In synthesis, Foreign Direct Investment encourages important productive process and simultaneously builds one part of power elite.

A second point for reflection concerns the nature of investments: whether they are carried out with the aim of tapping the internal market of the host country or of boosting exports; whether the foreign investor is being financed in his country of origin or through international funding or whether the investor resorts to sources in the country in which it is establishing itself.

A third consideration has to do with economic policy: for Foreign Direct Investment activities to be beneficial to the country involved, they must be effectively coordinated with local economies and integrated in the overall economic policy. At the legal level, the conditions governing the implementation and functioning of Foreign Direct Investments were liberalized, and certain crucial incentives were offered, particularly tax incentives. Making these investments consistent with the interest of the nation will require the establishment of regulatory standards.

Fourth, there is also a clear need to avoid risks that may lower the contribution of these investments to national development: excessive imports, the substitution of internal savings for external savings, excessive remittances of profits and obstacles to technological research.

There is no doubt that foreign direct investments must be placed within a long-term framework and must be viewed from the perspective of a national development project. They should be committed to the development of the host country, a fact that tends not to be consistent with their aspirations to increase markets and to raise profits.

Today, the globalization on Foreign Investments, capital markets and international financial are organized in large measure by Multi National Corporations. Their pre- eminence in world output, trade, investment and technology transfer is unprecedented. Even when MNCs have a clear national base, their interest is in global profitability above all. MNCs have grown from national firms to global concerns using international investments to exploit their competitive advantages. Increasingly, however, they are using joint ventures and strategic alliances to develop and exploit those advantages or to share the costs of technological innovation. But the growing globalization of production is not limited to MNC activity, for over the last three decades there has been a significant growth in producer - driven and buyen – driven global production and distribution networks. The globalization of business is thus no longer confined to the MNC but also embraces Small and Medium-sized Enterprises (SMEs).

Rather MNCs play a much more central role in the operation of the world economy than is the past and they figure prominently in organizing extensive and intensive transnational networks of coordinated production and distribution that are historically unique. MNCs and global production networks are cirtical to the organization, location and distribution of productive power in the contemporary world economy.

Foreign direct investment (FDI) can provide benefits to host countries and regions through new jobs and the possibility for technology transfer and productivity improvements in domestic firms. However, these benefits may not always be realized, and there may be offsetting costs in terms of reduced employment and market share among domestic firms.

The relevant modern technology has changed the management of financial transactions investment in ways that have expanded international capital flows. It is also financial technology that has encouraged and increased the international flow of investment. Derivative markets allow investors to separate cross-border equity or interest rate risk from cross-border currency risk by hedging the currencies associated with equity or bond positions. This hedging may help to explain the an important but still inadequately understood feature of the international capital market, it is mean the contrast between the very large volume of gross flows and the very small volume of net flows.[16]

The most obvious contribution of Foreign Direct Investment and international capital flows to host countries is to augment the supply of domestic saving in countries with unusually rich investment opportunities. The high marginal product of capital means that capital importing countries can benefit even when the interest rates and the equity yields to the foreign providers of capital are high.

Despite the importance of this contribution, it is important to note that the magnitude of the capital inflows is still small relative to the volume of domestic saving. Most of the investment in plant and equipment-technologies-and in real estate in every country is financed by domestic saving. This reflects the limited size of the current account deficits and the associated capital inflows that the international capital market will support.[18]

Direct foreign investment means much more than additions to the stock of capital. It brings with it better technology, modern management, and an expanded access to global markets. Portfolio equity investments also help in a different way by exposing local companies to the scrutiny of the international capital markets, requiring greater accounting transparency and more effective international corporate governance. Money goes where it wants, and stays where it is well treated.[19]

References

Contact the author for a list of references.

End Notes:

Contact the author for the list of end notes.

ANNEX: FIGURES

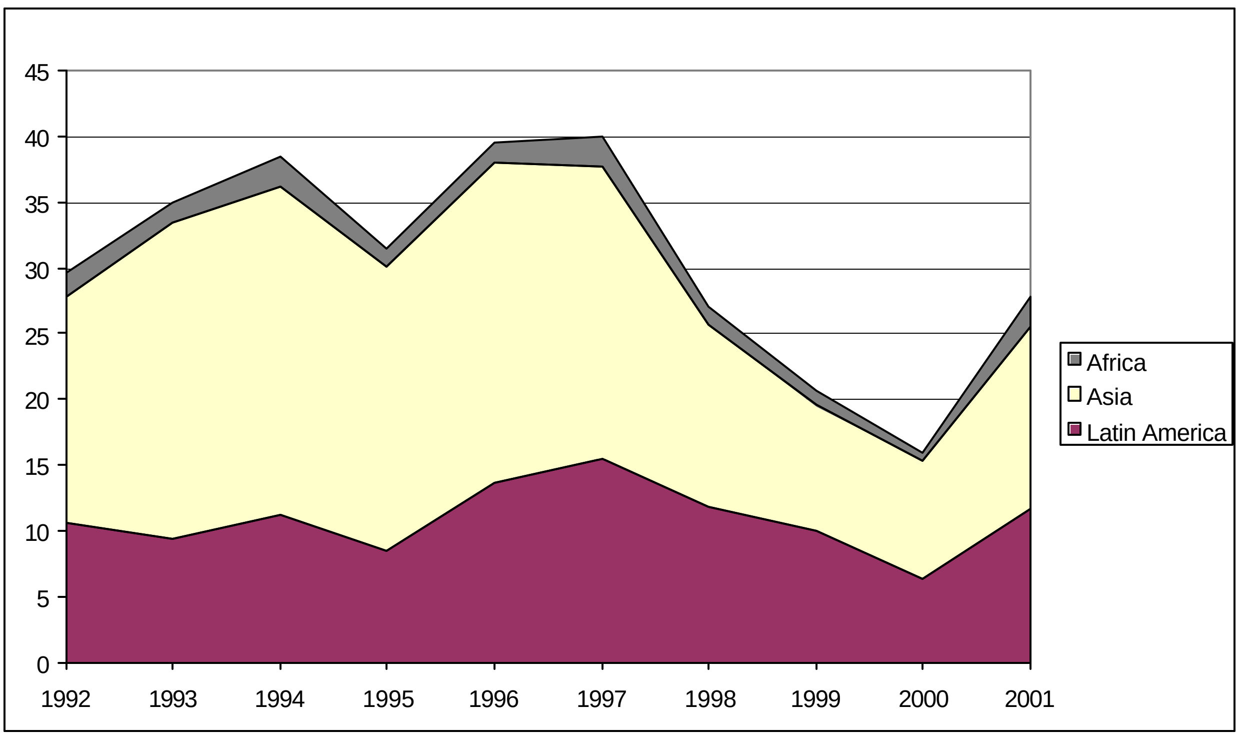

FIG. 1 DEVELOPING COUNTRIES' SHARE OF GLOBAL FDI INFLOWS

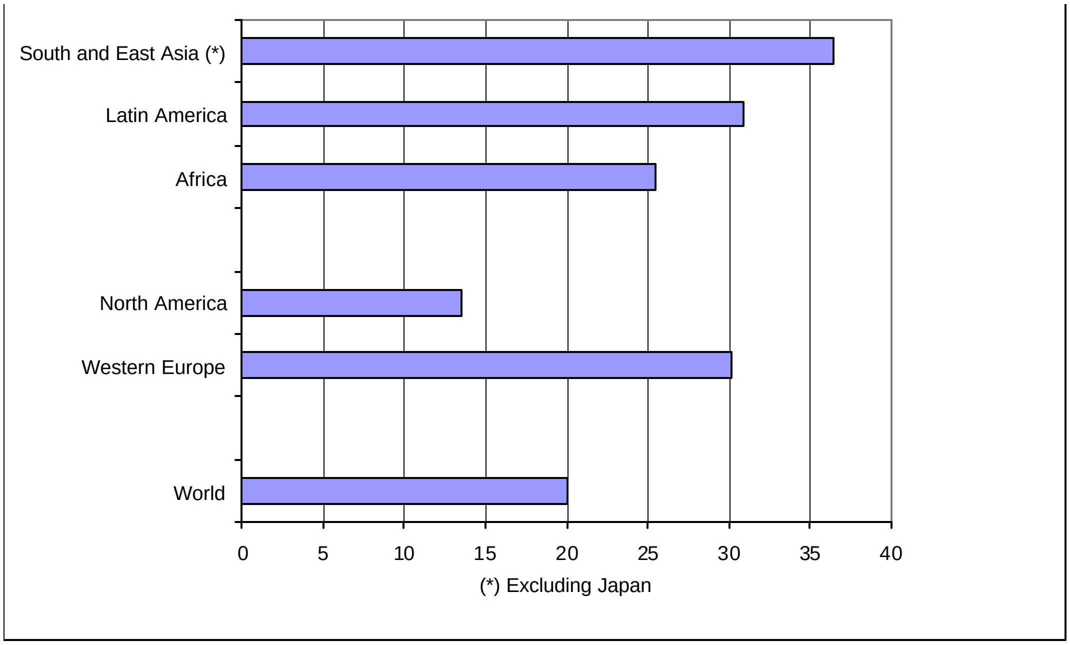

FIG. 2 INWARD FDI POSITIONS RELATIVE TO GDP

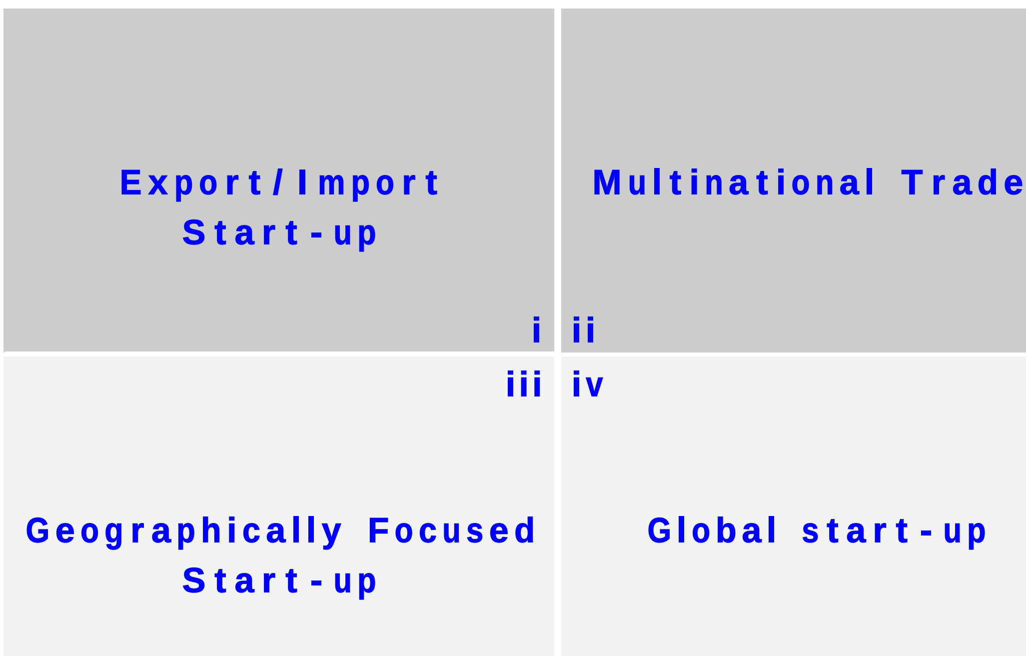

FIG. 3 TYPES OF INTERNATIONAL NEW VENTURES

Whither Foreign Direct Investment in Malaysia in a Volatile Global Business Environment?

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Abstract

This paper examines the growth trend, sector-wise inflows and economic impacts of FDI in Malaysia. The results show an increasing trend of foreign investment inflows during the period 1985 to 1996. A declining trend emerged in the post 1997 Asian Crisis period. The macroeconomic variables such as GDP, exports and employment are found to be positively influenced by the growth of FDI in Malaysia. To enhance the positive effect of FDI on the growth process in the country the flow of FDI into export-oriented sector and use of domestic inputs by the foreign-oriented firms need to be encouraged. It is suggested that for sustained flow of FDI, price stability, macroeconomic balances- both monetary and fiscal, good governance and continuation of economic liberalization are crucially important in Malaysia In the event of declining inflows of FDI, Malaysia has to shift towards inward looking policies and search other alternatives to sustain its growth and economic prosperity in the emerging modes of global trade and investment in a volatile business environment.

Introduction

Over the years in most developing countries foreign direct investment (FDI) as an effective source of foreign capital, has assumed a significant role in their development and industrial growth process. Especially, in the Asia-Pacific region high levels of foreign capital investment including FDI, predominance of multinational companies and export-led growth strategy and the market-oriented economic integration across the region largely comprise its business and economic growth model. By and large, in most developing countries FDI is regarded as an engine of growth.

In the Asia –Pacific belt among ASEAN countries, however, Malaysia has acquired a unique position of rapidly growing newly industrialized open economy in the past two decades. As such, it is worthwhile to examine its growth characteristics in the light of FDI inflows in its development process, performance and prospects.

Rationale for the Study

A plethora of studies on the issues of FDI is available in the context of developed and developing countries. Since the present study is confined to the Malaysian case, it is needless to go through the wilderness of all these studies.

In the post-Asian 1997 Crisis era, the growth scenario of the ASEAN countries has a different story about the flows of FDI. Besides, international business environments are rapidly changing in the accelerated pace and processes of globalisation, growth of economic imperialism of the super powers-possessed by the countries and corporations, and emerging new great markets like China and India. In this regard, a fresh look and discussion is warranted on the issues of FDI in developing countries to serve as guidelines for the policy-makers in determining their future course of direction. Malaysia, however, provides on example of one of the most successful cases of the newly industrialized country (NIC) to attract large quantum of FDI in the pre-Asian Crisis years. Indeed, despite the 1977 economic crisis, the Malaysian policy makers never marginalise the importance of FDI as a growth propelling force. The Government of Malaysia did recognise the varying impact of different investment inflows by offering multinational corporations (MNCs) several incentives including liberal ownership rights and taxations allowances. Looking to the pragmatic approach and efforts of her policy-makers, thus, Malaysia serves as an interesting case to analyse the issue pertaining to foreign direct investment flows that might provide some useful lessons for other developing countries in Asia and Africa.

Incidentally, available studies on FDI in Malaysian context have tackled various issues in segregation and most of them have been descriptive in approach. Some (Ariff 1992, Aware and Metussin 1999, and Bhatt 2000, for instant) have focused on the ASEN region and made a peripheral reference to Malaysian situation. Fry M.J (1994) observed an inverse saving-investment correlation in Malaysia over the period 1979-91. This is attributed to public sector investment and FDI. Hill (1990) provides an explanation to this by saying that Malaysian authorities might have preferred FDI to local non-indigenous (non-Bumiputras) investment to check the racial economic imbalance in the country. Comprehensive study of recent Malaysian experience is yet unavailable. An attempt is made in this paper to fill up the gap to an extent.

In particular, this paper has three-fold objective. Firstly, to review the trend and pattern of foreign direct investment (FDI) inflows in Malaysia, secondly to examine the impact of the FDI inflows on Malaysian economy and finally to discuss the interface of the country with the AFTA (the Association for Free Trade Area) and make inferences towards its future prospects.

FDI: Growth Trends in the ASEAN and Malaysia

Globally, FDI has increased dramatically over the years. (Refer to Table 1 for details). The inflows of FDI, however, have largely been channelised towards industrial contries. Even by 2001, developed countries remain the prime destination of FDI, accounting for mare than 75 percent of global inflows. In the developing countries, FDI has grossly concentrated among a few natins. In 1990,over 90 percent of FDI hads flown to eighteen developing countries, and half of which was claimed by eight South-east Asian countries (Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand), on accunt of their growing market economies, competitive capacities of domestic business groups, economic imperatives, such as a deteriorating current account over a period, and increasingly open and receptive policy providing superlative investment climates (see Fry, 1991,1993 and Hill,1990).

TABLE 1: WORLD FDI INFLOWS AND OUTFLOWS

(USD Billion)

	FDI Inflows	FDI Outflows
1970	12.59	14.11
1980	54.95	53.67
1984	60.18	52.77
1985	57.60	62.16
1986	86.44	97.83
1987	139.84	142.28
1988	163.76	177.57
1989	192.56	227.65
1990	202.78	233.32
1991	160.20	198.01
1992	171.20	201.51
1993	227.53	243.90
1994	257.90	286.67
1995	330.5	356.4
1996	386.1	394.9
1997	478.1	474.0
1998	694.5	684.0
1999	1088.2	1042.0
2000	1491.9	1379.5
2001	735.2	620.7

Source: UNCTAD, World Investment Report, 1998

By and large, FDI has played a key role in development process of the major ASEAN countries including Indonesia, Malaysia, Philippines, Singapore and Thailand. Mid-Eighties onwards till the Asian Crisis of 1997, the ASEAN region has been highly successful in attracting large inflows of foreign direct investments in the developing Asia. During 1985, for instance, the world FDI inflows amounted to USD 576 billion of which the ASEAN received

USD 2.2 billion thus claiming just 3.8 percent share. There has been a quantum jump in 1995,when the ASEAN claimed USD 25.3 billion from the total world FDI inflows amounting to USD 330.5 billion, which implied nearly doubling of its share (at 7.7 percent). In 1997, the world FDI inflows increased to USD 478.1 billion of which the ASEAN received 30.4 billion, claiming 6.3 percent share in the total.

TABLE 2: FDI INFLOWS IN MALAYSIA AND ASEAN (1970-2001)

(In US Millions)

	Malaysia	ASEAN
1970	94	374
1980	934	2415
1981	1265	3537
1982	1397	3448
1983	1261	3163
1984	797	2754
1985	695	2229
1986	489	2841
1987	423	4305
1988	719	7002
1989	1668	7591
1990	2611	12740
1991	4043	13619
1992	5138	12699
1993	5741	16602
1994	4581	20399
1995	5816	25367
1996	7296	29370
1997	6324	30370
1998	2714	18505
1999	3895	19691
2000	3788	11055
2001	554	13240

Source: UNCTAD, World Investment Report, 2002

Data in Table 2 suggest that in the post-1997 Crisis period, the ASEAN experienced a declining trend of FDI inflows from 18.5 billion in 1998 to 11.1 in 2000, as against the rising trend of the world FDI inflows from 694.5 billion to 1491.9 billion in the same period. This is attributed to a diversification of the world FDI inflows towards other channels – the new emerging markets such as China, India and African countries.

Malaysia, on the whole, represents a rising trend of FDI inflows over the years since 1970.During seventies and eighties, from the bottom of 94 million FDI inflows in 1970, the Malaysian economy had received a peak level of 1397 million FDI inflows in 1982.Its share in the ASEAN FDI inflows, thus increased from 25 percent to 41 percent.

During 1985-2001, the compound annual rate of growth (CARG) of the FDI inflows in Malaysia estimated to be 12.4 percent as against that of 10.6 percent in the case of ASEAN.

During 1986-91, the annual average FDI inflows estimated to be USD 1605 million in Malaysia, which constituted around 20 percentage share in the annual average flows amounting to USD 7908 million in the ASEAN region. During nineties, prior to the crisis year 1997,the Malaysian economy witnessed an increasing trend of FDI inflows from 695 million in 1985 to 2611 million in 1990 to the peak level of 7296 million in 1996.

The rising trend in the inflows of FDI in the country may be attributed to the policy shift and growing market orientation of the country. The other important determinant of FDI inward flows to Malaysia during this period is the successful industrial and technological upgrading acquired in achieving a competitive edge in the export markets.

A setback is, however noticed in the post-1997 Crisis period. The FDI inflows in the country shrinked to 2714 million in 1998.In the recovery period 1999 onwards again the rising trend is noticed. The FDI inflows in the country increased to 3895 million in 1999.The FDI inflows, however, marginally declined to 3788 million in 2000.

Sector- wise Pattern of FDI in Malaysia

Malaysia attracted foreign direct investment even in the British regime prior to her independence in 1957.In the beginning the multinational companies were concerned with seeking raw materials such as rubber and tins from the country. Gradually, as an impact of the country's new economic policy of 1970, there was a marked diversification of the FDI inflows towards manufacturing sector; (basically a large channels in the electronics and textiles). The FDI inflows also went into wood, wood products, fixtures, paper, printing and publishing, plastics, machinery and equipments and measuring equipment industries of the country. In recent years, high-tech and such other industries requiring extensive R & D has received a greater attention of the MNCs in Malaysia. Over the years the manufacturing sector received the largest share of foreign direct investment in the country in 1986, this sector receives 93.33 per cent of non-oil sector FDI. (Refer to IMF, 1987).

In 1991, however, the share of manufacturing investments dropped almost 10 per cent on the average. This is partly due to expansion of the property sector from 2 percent in 1989 to 13 percent in 1992. Ironically, the drop in manufacturing is partly due to the challenges faced in Malaysian labour market. The rapid decline of 'low-technology' and labour-intensive industries implied that the labour markets in the country have become increasingly tight. Malaysia should uplift the workforce to develop more skill- and technology-intensive industries. During 1995-1997, the agriculture, manufacturing and property sectors claimed 2 percentages, 78 percentages and 20 percentages respectively in the total inflows of FDI in the country.

Current scenario

FDI inflows in major ASEAN countries are least affected by the 1997 economic crisis. In the case of Malaysia and Thailand with a marginal set back in the investment applications in 1997, soon there has been an upturn in FDI activity in 1998 onwards. Malaysia has successfully attracted FDI in the manufacturing and electronic sectors to a large scale.

Recovery measures undertaken by the Government in Malaysia has shown some positive results. The country had speedy recovery form the 1997 crisis is evident by the fact that its economy depicted a strong 11.7 percent growth in the first quarter of 2000. In 1999, real GDP increased by 5.6 percent, rebounding form the recession (7.4 percent economic contraction) in 1998. Consequently, foreign investor sentiments towards Malaysia supposed to have improved. Yet, the amount of foreign applications for manufacturing projects dropped 16.4 percent to RM2.5 billion during January –May 2000, compared to RM3.0 billion during January –May 1999. This compares very unfavorably against the amount of RM6.0 billion during same period in 1998 and RM 5.6 billion 1997. Malaysia now ranks fifth form previously number one before the crisis within ASEAN as a recipient of Japanese FDI, next to Singapore, Indonesia, Thailand and Philippines. An official research is needed to find the reasons involved and the government should try to improve upon the situations. Perhaps, one of the reasons may be assumed to be the phenomenon of the exchange/ capital control and imposition of exit tax. In the ASEAN region Malaysia is unique in this regard; hence, it might have become less attractive venue for FDI inflows in comparison to many other competitive developing nations. For an effective control of short-term capital flows, thus, we side with the MIER view that foreign capital should better be regulated at the entry rather than at the exit point. Mechanism may be devised to make it compulsory for inflowed funds to be deposited in the central bank (Bank Negara Malaysia) interest free and should be charged with a penalty (say 10 percent) when it is out-flowed within a period of less than one year; at the same time, provision for a reasonable interest payments is justified for funds retained for longer period. (See, MIER, 2000).

Table 3: CROSS-BORDER M&A PURCHASES BY MALAYSIAN ECONOMY (1990-2000)

(In USD million)

	Malaysia	ASEAN
1990	144	630
1991	149	747
1992	148	2,513
1993	774	4,319
1994	812	9,978
1995	1122	8,305
1996	9635	11,564
1997	894	9,828
1998	1059	_
1999	1377	_
2000	761	_

Source: UNCTAD, World Investment Report, 2001

In recent years, across border Merger and Acquisition (M&A) activity caused increasing share of a country in the expanding global FDI inflows. Data in the Table 3 relate to the cross border M&A purchased by Malaysia during 1990-2000. It shows that from the bottom of USD 144 million in 1990 the amount of the cross border M&A purchase of the country had gone up to a peak level at USD 9635 million in 1996. A declining trend is, however, noticed in the post crisis period since 1997. It has decline to USD 761 million in 2000. As per of the World Investment Report 2002, the world FDI inflows declined to USD 735 billion in 2001, as against that of 1492 billion in 2000. This is attributed to slow down of the world economy and weakening of business confidence and prolonged recession in the global economy. Nevertheless, the expansion of international production continued at a slower pace. In comparison to the lower level of inflows to Asia, Malaysia's record at FDI inflows in the post 1997-Asia crisis period is not very discouraging. In the ASEAN region, however there is an increase in the FDI inflows to USD 13, 240 million in 2001 as against that of USD 11,055 million in the previous year. In Malaysia, the FDI inflows substantially decrease to USD 554 million in 2001 as against that of USD 2026 million in 2000.

The Impact of FDI in Malaysia

Below an attempt is made to trace the impact (time-trend effect) of FDI on the country's Gross Domestic Product (GDP), exports and employment has been traced. In empirical measures we have worked out the time-trends of FDI relating to the concerned variables, for tracing the income effect, export effect and employment effect of the FDI inflows in the Malaysian economy during 1985-2000.We have used the SAS Programme software for the least square regression analysis of the data and our results are discussed below.

The Income Effect

In a developing open economy, the inflows of FDI considered to be an important source of capital formation and expanding business activities that stimulates a rise in the domestic output and income of the country. The inward FDI flows as a percentage of gross fixed capital formation (GFCF) in the Malaysian economy is estimated to be 14.7 per annum on an average from 1986-1991. In 1992, it was at the peak of 26.0 percent and declined drastically to 11.0 percent in 1995 (See Table 4 for details).

Table 4: INWARD FDI FLOWS AS A PERCENTAGE OF GROSS FIXED CAPITAL FORMATION (GFCF) IN MALAYSIA AND ASEAN (1986-2000)

(Percentage)

	Malaysia	ASEAN
1986-91 (Annual average)	14.7	-
1992	26.0	-
1993	20.3	-
1994	14.9	-
1995	15.0	11.0
1996	17.0	11.0
1997	15.0	12.0
1998	14.0	12.0
1999	22.0	12.0
2000	17.0	6.0

Source: UNCTAD, World Investment Report, 2001

The following double log linear lagged model is estimated to capture the direct elasticity of FDI on GDP:

$$Ln\ GDP\ (t) = b_0 + b_1\ ln\ FDI\ (t) + b3\ ln\ FDI\ (t-1) \quad (1)$$

Where,

GDP = Gross Domestic Product
FDI = inflow of FDI in the country
t = time in the period of year
t-1 = previous year.

For the Malaysian case, our estimate is stated, thus:

$$Ln\ GDP\ (t) = 8.561 - 0.142 \ln \text{FDI (t)} + 0.586 \ln \text{FDI (t-1)} \quad (2)$$
$$(-1.144) \qquad (4.574)$$

R^2 = 0.733

(Parentheses represent t values)

The model is a good fit explaining 73% of the variations. It suggests that FDI in the previous year causing a positive effect on rise in GDP in the current year. Over the years, a large part of growth in Malaysia's national income can be rightly attributed to the positive income effect of the FDI inflows.

The Export Effect

From host country's view point, FDI is warranted owing to its certain positive effect such as it leads to increase in the volume of trade, (especially, exports) improvement in the production functions due to transfer of technologies and managerial know-how resulting to into enhancement of economic efficiency as a whole. Much of the growth in Malaysian grew in the range of only 2 percent prior to 1975. By 1980, Malaysia had become an important producer and exporter of finished manufactured and semi-manufactured product, thus setting out the foundation for rapid and balance growth in the export sector.

TABLE 5: MACROECONOMIC INDICATORS OF MALAYSIA
(million)

	GDP MARKET PRICE	EXPORT	EMPLOYMENT
1985	77470	37576	5.6246
1986	75194	37976	5.7065
1987	79625	44733	5.8808
1988	90861	54607	6.0875
1989	101463	66727	6.3508
1990	115201	77458	6.621
1991	129381	92226	6.891
1992	148357	100910	7.096
1993	165206	118383	7.396
1994	190274	148506	7.618
1995	218726	179491	7.915
1996	249784	193363	8.161
1997	281795	217712	8.391
1998	283243	281947	8.572
1999	300764	319568	8.869
2000	342157	374033	9.271
2001	334589	334326	9.535
2002	355493	349471	9.843

Source: Ministry Of Finance, Economic Report, Various issues.

As can be seen from data in Table 5, the Malaysian exports amounted to RM425.43 billion in 1985. After a slight drop in 1986, experts grew steadily to RM901 billion at an average growth of 16 percent. This was the outcome of the 1986 Industrial Master Plan (IMP) that aimed to further diversify the value added manufacturing product for the export base.
The country exports grew rapidly to reach the peak of RM3632 billion in 1999. It has been observed that the growth rate was at 22 percent in average during 1991 until 1999.For capturing the impact of FDI on Malaysian exports; we used the following double log linear lagged model for regression analysis.

$$Ln\ EXP\ (t) = bo + b1\ ln\ FDI\ (t) + b2\ lnFDI\ (t\text{-}1) \qquad (3)$$

Where,
EXP = Exports
FDI = inflow of FDI
t = current year time in the period
t-1 = preceding year time in the period.

Our result is stated as under:

$$Ln\ EXP\ (t) = 6.951 - 0.190\ ln\ FDI\ (t) + 0.801\ \ln\ FDI\ (t\text{-}1) \qquad (4)$$
$$(-\ 0.969) \qquad\qquad (3.977)$$

$R^2 = 0.677$
(Parentheses represent t-values)
It is seen that the lagged determinant (FDI (t-1)) is highly significant, thus, implying that exports tend to rise only in the subsequent years of initial FDI inflows. It follows that the country's export-led growth strategy has succeeded on account of the positive export effect of the FDI inflows over the years.

The Employment Effect

Foreign Direct Investment is assumed to generate employment in a developing host country. To capture the employment effect of FDI in Malaysia, we worked out the following double log linear lagged, model:

$$Ln\ N(t) = b0 + b1\ ln\ (FDI\ (t) + b\ 2\ ln\ FDI\ (t\text{-}1 \qquad (5)$$

Our result is stated thus:

$$\text{Ln N (t)} = 0.944 - 0.054 \text{ ln FDI (t)} + 0.188 \text{ ln FDI (t - 1)} \qquad (6)$$

$$\qquad\qquad (-1.303) \qquad\qquad (4.431)$$

$$R^2 = 0.706$$

. (Parentheses represent t-values)

The result indicates the inflows of FDI in the proceeding years have been much significant in generating employment in the current years. This is obvious since time lags are functionally involved in the process of production and job creation in real terms. Indeed, the Manufacturing Census data of 1968, 1973 and 1981 revealed that of the total number of jobs created in the manufacturing sector (400,000), 30 percent was on account of FDI inflows.

The aforementioned discussion implies that the inflows of foreign direct investment in Malaysian economy tend to have a favorable impact on exports, employment and income generation.

Malaysia's Propensity to Attract FDI

The relative performance of a country in attracting FDI can broadly be examined with consideration of its relative economic size and strength on position in the global economy. A new measure called the Inward FDI Index (IFI) suggested by the world Investment Report 2001 in this regard. The Inward FDI Index (IFI) is measured as follows:

$$IFI = \frac{(FDI/WFDI).}{\left[\frac{CGDP}{WGDP} + \frac{CN}{WN} + \frac{CX}{WX}\right]}$$

Where,

CFDI = the country FDI inflows
WFDI = World FDI inflows
CGDP = the country domestic product
WGDP = the aggregate world GDP
CN = the country employment
WN = the world employment total
CX = the country export
WX = the world export total

The inward FDI Index (IFI) reflects a country's propensity to attract FDI after adjusting for its relative's economic size and strength (international exposure/position) in the global economy. It's a measure for the policy makers to compare how well their country performs in attracting FDI relatives to others.

Interestingly enough, according to the World Investment Report (2001), Malaysia with IFI >1 was placed 17^{th} in the rank among top 30 high performance nations during 1988-1990. In 1998-2000, however, Malaysia turned up as a "balanced" country (other balanced countries include Costa Rica, El Salvador, Hungary and Slovenia) with the Inward FDI Index of one with their share of FDI inflows exactly matching their average shares of worlds GDP, employment and export. There are 53 country with IFI > 1 and 79 with IFI <1. Majority of the developed countries, also Hong Kong, China and Singapore with IFI >1 regarded as the "over performance" nations. While Japan, Italy, Greece, Taiwan, Turkey, and Saudi Arabia and low income countries with IFI<1 are classified as "under performance" nations. Incidentally, Singapore has slipped from the first rank in the high-performance group in the end-eighties to the thirteenth position in the end-nineties. Apparently, the slippage of the Singapore as well as Malaysia is attributed to the Asian Financial Crisis in 1997. Besides, Malaysia's competitive strength is remarkably good among the developing nations. As per the World Competitive, on the strength of the competitiveness, Malaysia was ranked 9^{th} among the 53-selected country and 2^{nd} (next to Singapore) among the ASEAN country.

Towards New Paradigms and Strategies

In the global context, Asia (ASEAN too) is facing currently a great pressure of economic slow down owing to external driven and trade oriented recessions, cocurrent problems in many parts of the world, structural transitions and financial constraints. Future prospects of FDI in the ASEAN countries, and particularly n Malaysia, need to be examined in the context of AFTA (the Association for Free Trade Area) in the Southeast region. Besides, emergence of new big markets China and India plus increasing openness of Viet Nam and African countries in the wake of the 21st Century has posed new challenges. Time and again, global business environment is becoming more volatile due to unexpected events and uncertainties. Recently, the world will gloom by the disasters of two US-led wars and epidemic such as SARS (Severe Acute Respiratory Syndrome).

Below an attempt is made to discuss some such challenges as well as opportunities juxtaposed to the future course of FDI in the Malaysian context.

Interface between AFTA and Malaysia

The AFTA was established in January 1992 with a view to enhancing economic development, growth and linkage of economic cooperation among the ASEAN countries through creation of a free trade and investment regime in the region. It aims at creating an integrated regional market and strengthening member countries' competitive advantage in the global arena. The AFTA is to position the ASEAN as regional investment avenue to continually attract FDI inflows under the situation of volatility that may be caused by the emerging competitive great market such as China and India. The AFTA is intended to be complementary to the forward and outward-looking ASEAN countries in their export- led and investment –oriented growth strategies. Essentially, the objectives of AFTA are to be realized through a tariff reduction scheme – called the Common Effective Preferential Tariff (CEPT) Scheme – for manufactured goods as well as processed and unprocessed agricultural products. The scheme is to effectively reduce tariff rates for all relevant products at the level 0-5 percent by 2002/2003. By now, 96.6 percent of Malaysian products are covered in the CEPT scheme of which 91.7 percent are subject to tariff rates between 0-5 percent. Almost 60 percent of the products have zero tariffs. In the year 2000, the average CEPT tariff rate for Malaysia's products were 2.8 percent, which is expected to decline further to around 2 percent in 2003. However, automotive products, unprocessed agriculture products in the sensitive list and products in the General Exception list are yet to be included into the CEPT Scheme.

TABLE 6: INTRA-ASEAN TRADE, 1993-2000

	1993	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**
Intra-ASEAN trade (US billion)	89.7	115.7	132.5	155.2	131.1	138.5	141.0	179.7
Total global trade of ASEAN country (US billion)	432.0	545.0	651.0	706.6	623.2	624.4	646.6	782.7
% of Intra-ASEAN trade of ASEAN's global trade	20.76	21.23	20.35	21.96	21.04	22.18	21.81	22.96

Source: ASEAN Secretariate

With reduction of tariffs and trade barriers envisaged under the AFTA, it is expected that the infra-regional trade and investment will increase and integrated markets will tend to improve resource allocation within the region. Data in Table 6 suggests that infra-ASEAN trade has steadily rising trend, from USD 89.7 billion in 1993 to USD 179.7 billion in 2000. The compound Annual Rate of Growth (CARG) is measured to be 10.4 percent. On the other hand, the percentage of the infra-ASEAN trade to ASEAN's global trade over the years has remained stable at around 21 percent.

The AFTA as a single regional market constitutes a high potentiality for business, owning to estimate population of 513 million and a combined national income of USD 580.2 billion and per capital income of USD 1,121 in 2000. Collectively, the ASEAN stands a better chance of competing against the mighty China.The ASEAN economy can be treated as a big integrated market caused by the removal of trade barrier and infrastructure linkages transport, energy and telecommunication systems. The emergence of China's big consumer market should be considered as growing opportunities through supply chain alliance "AFTA-China" Business Strategy – that constitutes the world's largest regional trade bloc with a market containing 1.8 billion people clubbed with over USD 2 trillion GDP, and total two-way trade of USD 1.2 trillion. As a matter of fact,"AFTA-China"has created a new business environment that should provide fresh impetus to the ASEAN members for growth and prosperity.

Malaysia has a potential to grab the economic opportunity, as the AFTA facilitates specialization on the basis of comparative and competitive advantage, technology transfer among businesses, improved resource pricing and better management. Malaysia's economic policies are conducive in this context. The New Economic Policy (NEP) of 2001 has the common goals towards the country's economic development aspirations. Essentially, the Malaysian approach is a strong exponent of trade liberalization and multi lateral trading system.

Among the ASEAN nation, Malaysia enjoys the relative competitive and comparative advantages in certain industries, such as in terms of low import taxes on chemicals, electronics and ICT, raw materials coming from industries outside ASEAN, relatively trained and educated workforce, market-friendly government policies-initiatives and support, and political stability.

Due to the Information Technology (IT) sector advancement, Malaysia has a comparative advantage in the development of knowledge-based economy. Multimedia Super Corridor (MSC) has provided the further impetus to the growth of the information and communication technology (ICT) industry in Malaysia. By March-end 2002, there are 657 MSC-status companies, of which 30 percent are world class and 32 percent are foreign owned, with many doing their business in the regional and global markets. With a focus on this area it can accelerate it the nation growth process even with declining FDI flows in the near future.

Malaysia should evolve a mix of outward and inward looking growth strategy. With the e-ASEAN initiative, Malaysia can exploit the situation of growing opportunities as supplies of ICT products and technology through domestic output as well as outsourcing. Malaysia should search the potential for outflow of its direct investment in the promising ASEAN countries such as Vietnam, Thailand, and Philippines. The country can also assume leadership role of IT sector development in the promising Muslim countries and African nations. Even Iran and Iraq (in future) can be the host country for the Malaysian direct investment. Through cooperation and economic ties with countries such as India and Sri Lanka, there is enormous potential for the economic prosperity of Malaysia. Malaysia should try to come out as the leading suppliers of ICT products, knowledge and technology management and center for higher education and training for uplifting the base of knowledge in the emerging markets in Asia and Africa.

Currently, Malaysian economy is skewed with a greater reliance on the US economy. The country needs to balance out its global economic position by improving its trade and investment relationship with the European Union. Its foreign reserves composition should scale up with equal proportion of 'Euro' with 'US Dollar in due course of time.

Of course, Malaysia need to evolve new paradigms (such as six-sigma system, IS 14,000, total ICT-orientation as norms-improvement system) as productivity and quality will be the hallmarks in gaining strong foothold and seizing the emerging opportunities in the regional pockets of the global economy. Serious efforts are required on productivity aspects and quality improvement and competitive pricing for an increased level of Malaysian exports in years to follow. It is possible with integration, dedication and techno-economic cooperation of the ASEAN countries.

Furthermore, Malaysia needs to re-evaluate its existing manufacturing-centered economic model. There is a need to build it towards higher-value activities of service industry and knowledge based ICT industry, so that it becomes a more attractive investment venue for foreigners. Malaysia has this potential which is yet untapped adequately in proper direction. The Malaysian Government needs to chalk out the necessary incentives through appropriate policy measures in this regard.

The IMP2 and FDI

Incidentally, the Second Industrial Master Plan (IMP2) leads the strategy to attract investment with high value-added industries against the phasing of labour-intensive industries. It promotes the 'Manufacturing Plus Plus' concepts and chances for better and greater industrialisation. The plan envisages the qualitative trend of FDI; strengthen global competitiveness and productivity on the prime motivation for the future course of direction and development

The country needs to increase its domestic investment level. It has the potential, with its saving ratio being 38 percent and there are untapped natural resources and knowledge-human-technical resources. The Malaysian policy makers ought to improve the share of domestic investment to make up 60 percent of total investment in long term. In 1996, however, the ratios of domestic investment to foreign investor stand at 50.1 percent as against total of 56.2 percent in 1995.The decline is attributed to the higher inflow of foreign capital in the year. But the 1997 crisis, and emerging uncertainties due to wars and epidemics in the current year (2003), the situation has become more alarming. The major problem is of declining investment efficiency. As seen through incremental capital-output ratio that has gone up from 3.0 in 1988 to 6.5 in 1997 in the Malaysian economy, it critically warrants two things: Firstly, improvement in overall factor productivity and enhancement of efficient use of capital to lower down the incremental capital-output ratio. Secondly, the need to increase domestic investments to compensate for the declining flows of the FDI. The distress of 1997 reaffirm that the country also needs to structure to make it strong and stable, with an effective intermediary function, mobilisation of saving and productive allocations of the resources.

By and large, Malaysia's future depends on mitigating threats and converting the opportunities and building its strength, overcoming weaknesses through implementation of various strategies and initiatives at the local, national, regional and multilateral levels. There is also a need to revitalize and redesign management practices by evolving a Malaysian-centric style of management to motivate the Malaysian workers towards both 'hard-work' and 'smart-work' with greater devotion and sincerity for the betterment of self and society together. Imperatively, being an economy in the global setting, Malaysia has to maintain a stable, balanced macroeconomic environment through a 'mix' of prudent monetary exchange rate, fiscal and trade policies contributing to its expert-led growth strategy centered around the attracting foreign direct investment with due diversification, and to further reform and development of its banking and financial system. The country should tighten its linkages with China, Japan, ASEAN, USA, and with the European Nation as well as India, Sri Lanka, Africa, Egypt, Iran and Iraq in due course of time. It can gain trough 'Give and Take' Policy with the emerging markets of Asia and Africa.

In the first and second quarter of the year 2003, many Asian Countries including Malaysia have been subject to business drifts and slow down of their economies due to the war in Iraq and SARS. To promote growth and investments, Malaysia needs to deal immediately with certain issues such as implementation of the productivity-linked wage system, the abolition of the Automatic Pricing Mechanism, scrapping the (AP) Approved Permit (AP) control on steel products and cut on EPF contributions (Navaratnam, 2003).

The American Malaysian Chamber of Commerce (AMCHAM) observed that several investment projects have been missed by Malaysia on account of the failure of the Government Agencies in attracting large companies. Foreign investors have been frustrated over the many outstanding issues such as immigration hurdles, need for greater flexibility in equity structure requirement, reduction and simplification of the application and processing time for application for pioneer status. In this context, the Government should set up one-stop Foreign Direct Investment Center. (See Navratnam, 2003). The policy makers should endeavor to increase transparency, quick decision making, reduce bureaucracy, improve administrative efficiencies, and provide greater facilitation of business and foreign investment. If the public officials are not ready to change their attitudes and policy norms, the country will have to bear the fate of declining FDI in these days of stiff competition in the global economy. Though the country's economic fundamentals are supposed to be strong enough, the nation must gear up to meet the emerging challenges and uncertainties time to time.

Summing Up and Concluding Comments

This paper examined the major impacts of foreign direct investment (FDI) in Malaysia economy, following the review of growth trend of FDI during 1985 to 2001.

The flows of FDI have contributed substantially to the Malaysian economy's path on the emerging as a newly industrialized country within a short span of time. The country has provided a cost-competitive and growth potential environment for foreign investors. The Malaysian Government and its policy approach has always remained business-prone and market-friendly, by stressing on creation of necessary infrastructure, provision of incentives and administrative support for evolving a conducive environment for trade and investments

The results of empirical analysis in our study confirm the following hypothesises that:

- ?? GDP is positively related to FDI
- ?? Export volume has a positive trend in tandem with the flow of FDI
- ?? The FDI inflows have contributed positively in increasing the employment level in the country.

A number of policy implications follow form the study's findings. First, since FDI plays a positive role in Malaysia economic expansion, the government should continue to pursue the policies that encourage the inflow of foreign investment. Malaysian government should remain committed to its attributes of monetary and fiscal discipline essential towards macro balancing Regional integration will be a major explanatory factor of future patterns of FDI. Economic and political stability in Malaysia and its neighboring region is of the utmost importance if the region wants to attract FDI. Positive action should be taken to improve the country's eco-political risk rating to make it more attractive to foreign investors. This includes a wide range of policy options such as a reduction in crime, good governance and continued macroeconomic stability, besides the remarkable racial and social harmony of the country.

Stable economic environment is a pr-requisite for inducing FDI. Malaysia should continue to follow its course of fiscal, monetary, exchange rate and financial policies that has helped the country in macro balancing and creation of stable domestic economic and financial market conditions. Indeed, maximum benefit from FDI can be yielded in developing countries, which are free of domestic distortions such as financial depression and trade control. (Fry, 1993).

The policy-makers should encourage foreign -owned firms (F0Fs) to use locally produced inputs/materials a far as possible. Tax incentives may be given for using domestic inputs. Secondly export- led growth strategy of the country has shown positive results; therefore, activity of export-oriented F0Fs should be encouraged. Furthermore, for transformation of Malaysia's K-economy it is essential that F0Fs should be encouraged to participate in high-tech industries. The government should continue to follow its first wisdom and increase the share of expenditure on educational and labour training programme with a focus on human knowledge development in the country.

The Malaysian economy needs greater diversification in order to make it more resilient to the vagaries of the global trade cycles and the emerging and growing uncertainties of the world economic-political-social order. In the emerging knowledge-based economy, the flows of FDI will tend to be rising faster with a focus on the expanding service sector. Indeed, Malaysia has successfully marketed its services including construction, healthcare, education and tourism internationally. A further move in this direction will pay handsome rewards. Malaysia needs to revive its agricultural sector 5 as a move towards self-reliance and to check its food imports bills6. Malaysian agricultural sector can be upgraded and revolutionised through biotechnology. Malaysia needs to pose a long-term "Agrarian Policy Vision" to achieve self-sufficiency in food and other agricultural products through import substitution and thereafter creating surplus for export targeting. Indeed, the Malaysian Government has introduced the new agricultural policy[NAP](1998-2010) in this direction to improve agricultural productivity and output by dealing with problems of labour shortage, high labour cost, low productivity, need for modenisation of farming, production technology, storage, distribution network and marketing expertise and system. The country is aspiring to develop and exploit the potential as an international 'halal food-hub', pharmaceuticals, cosmetics and toiletries, and to utilise the rich biodiversity in due course of time.

In the Malaysia economy, time and again, the evolutionary process of FDI has excessively focused on production without bargaining much for transformation of technology. Alike other developing counties, the present kind of channelisation of FDI inflows in Malaysia is the least effective in preparing the Malaysian workers and entrepreneurs to meet the challenge of the new world of technological innovations. In the course of global FDI inflows a new trend is developing that the motivation of FDI is shifting from resource seeking to new advantages such as international alliances and innovation. Malaysia and other developing countries, therefore, have to change their policy strategies towards benefiting through such advantages. Investors also look towards more open and stabilization policies, simpler rules and regulations, transparencies and lesser government intervention in the market plays – unless inevitable for the preventive checks and positive results.

In Asia, Malaysia can be regarded as an attractive place to invest for her government has managed macro economic fundamentals commendably, She possesses a high level of skills, excellent infrastructure, improved corporate law enforcement, fewer and bigger banks, good governance of the financial institutions, harmonious, balanced and civilized multi-ethnic society, besides her exposure to lesser legal and political risks in comparison to several other counter-parts in the region. Malaysia should improve its Government public relations in exposing and justifying its policies and decisions containing hidden values to the prospective foreign investors from the West and elsewhere.

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Chasing the Dragon: Accounting for the Under Performance of India by Comparison with China in Attracting Foreign Direct Investment

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Abstract

This paper compares and contrasts the performance of India and China in attracting foreign direct investment (FDI). Both economies are large emerging markets that had rather similar profiles in 1978. Today, China ranks number one as the world's preferred foreign investment destination. Closer examination of the FDI statistics suggests that India's performance has been significantly understated while China's performance continues to be overstated. However India still lags for a number of reasons. These include a high tariff regime, poor infrastructure (power, ports, roads and railways), a regulatory system that is too often not business-friendly, a policy of reservation of many potentially export-oriented sectors for small businesses and inflexible labour laws. The government's large budget deficit is preventing investment in necessary physical infrastructure yet India needs to increase the rate of private investment to enhance the economic growth rate and reduce poverty. The paper concludes that based on China's experience of promoting FDI, further economic devolution to state level is the best way forward. While this is likely to exacerbate inter-state income inequality in the short term, it does offer the possibility of redistribution in the longer term.

Introduction

Over the last two decades the policy stance of governments in emerging markets towards foreign direct investment (FDI) has changed dramatically. This has been brought about by the mounting evidence of the positive association of FDI with increased growth rates and in improvements in total factor productivity (TFP) [see, for example, 8, 12, and 13]. Notwithstanding calls for a nuanced assessment of the spillover benefits of FDI from some observers,[i] FDI is much sought after by governments seeking a catalysing boost to economic growth through technology transfers, employment generation, improved access to managerial expertise, global capital and product markets, marketing and distribution networks. Multinational enterprises (MNE) seeking a global rate of profit are generally unsentimental about where it is achieved. A concomitant of the global trend towards increasingly liberal trade and investment regimes and fierce competition to attract investors is the need for serious investment and leadership by governments and their agents at many levels, to create and maintain the necessary business-friendly policy environment.

This paper will examine why India and China that represent examples of very large emerging markets perform so markedly differently in attracting FDI despite the increase in the importance of global drivers behind FDI. Explanation will be sought in the way in which national and sub-national governments have gone about the task of promoting inward foreign direct investment. It will also consider how the governments of the two countries have faced the challenge of reconciling the many, often contradictory, interests of groups affected by economic liberalisation and foreign investment in the domestic economy.

Attracting FDI

Conventional analysis of the drivers behind FDI focuses on the distinction between horizontal market-seeking investment and vertical cost-minimising investment seeking a low cost production location [see 26 and 44]. A large and growing market that permits economies of scale is particularly attractive to market-seeking investment. Market servicing costs that favour foreign direct investment over exporting include the presence of import tariffs, non-tariff barriers, transport costs and local competition offering customer responsiveness.

The strategic logic behind production cost minimising through overseas location is based on segmenting the value chain and relocating those parts that can benefit from inexpensive inputs whether they are raw materials, intermediates or a lower unit-cost of labour. In general, since this type of overseas production rarely includes the entire value chain, but is part of a geographically distributed production network, it is invariably export-oriented. As the key drivers behind the investment are cost differentials between locations, there is sensitivity both to changes in technology and wage rates impacting on unit costs and to overhead costs and incentives associated with particular policy regimes. Although evidence is ambiguous as to whether fiscal incentives directly influence FDI because of the political risk attached, tangible benefits such as provision of cheap land and appropriate pre-start infrastructure are often considered to be necessary if not sufficient conditions for FDI of this type [38]. A competitive fiscal regime is, at the very least, interpreted as reflecting a positive official attitude to the needs of business.

Recent work [3] suggests that global factors have increased in importance in explaining FDI flows. Using a large cross-country time-series data set, they model the significance of worldwide sources of risk that drive FDI across several countries. They conclude that in recent years, developing countries' exposure to global factors driving FDI has increased steadily and is now approaching that of developed countries.[ii] They identify capital market liberalisation and integration as the key driver. While [3] argue global drivers are increasing in importance, domestic drivers (growth in local productivity, trade openness, financial depth, low government burden and macroeconomic stability) still account for a sizeable amount of inter-country variation in foreign direct investment.

The impact of FDI on growth is complex. First, growth occurs through capital accumulation and the introduction of newer technology, management systems and innovative products associated with FDI.[iii] Second, FDI improves the efficiency of locally-owned firms through contact and demonstration effects and exposure to increased competition. Third, FDI under the right economic conditions leads to technological progress through the introduction of new varieties of knowledge-based capital equipment. Fourth, the FDI 'package' proceeds through specific productivity-enhancing management development and skills training programmes. Fifth, just as local firms learn from contact with FDI so do governments, institutions and public service providers. MNEs bring certain expectations about the quality of the business environment and the cost of doing business in a particular location to the bargaining table with host governments. They are often in a stronger bargaining position than domestic firms from which to persuade the authorities to introduce the necessary reforms. Last, preconditions in recipient economies – a liberal and efficient business environment including infrastructure, quality of human capital stock and the complementarity of existing firms – improve the conversion of FDI into higher levels of output.

Comparing the economic performance of India and China

China is a natural comparator for India for obvious geopolitical, economic and demographic reasons (Table 1). They both have populations in excess of one billion – China at 1.27 billion and India with 1.03 billion people in 2001. According to the World Bank [53], on a purchasing power parity (PPP) basis, they are respectively the second and fourth largest economies in the world. In A T Kearney's September 2002 survey of the leaders of the world's 1000 largest corporations anticipated FDI intentions and preferences; China was ranked first, ahead of the USA for the first time, as the most attractive investment destination in the world. India was ranked fifteenth, down from seventh in 2001.

It is when changes in the participation of India and China in world trade are compared that one of the sharpest differences between the two countries is apparent. In 1978 external trade represented around 12 per cent of GDP for India and 10 per cent for China (Table 1). By 2001, India's merchandise trade amounted to 19.7 per cent of GDP and China's trade had expanded to 44 per cent of GDP reflecting China's emergence as one of the world's major trading powers. In 2000, China generated 4 per cent of world merchandise exports compared to 0.7 per cent from India (Table 3).[iv] In terms of merchandise trade, China ranked as the seventh largest exporter and eighth largest importer in the world in 2002.

A major difference in the composition of the output of each country is the relative importance of the contribution of the service sector, particularly computer software, in India. When trade in services is included, India's relative openness to trade improves significantly. Trade in goods and services amounted to 28.6 per cent of

GDP in the case of India and 47.1 per cent of GDP in China. Even so, in 2001, China was a bigger exporter of commercial services ranking as the world's twelfth largest exporter while India was nineteenth.

One of the most obvious differences in the trade regimes of the two countries is the tariff regime. The average Most Favoured Nation (MFN) tariff rate in China has fallen from well over 50 per cent in the early 1980s to 15.3 per cent in 2001 [45]. India's standard applied MFN tariff averaged 32.3 per cent in 2001/2002 and is amongst the highest in the world [57, p.31].[v] In addition, there is a Special Additional Duty (SAD) which is estimated to raise the unweighted average customs duty on all goods to 35 per cent in 2002/03 [53, p.53]. The government's stated aim is to reduce the simple average applied MFN tariff rate to ASEAN country levels of less than 15 per cent [57, p.5].[vi] However this poses a major problem for the government because of its heavy reliance on customs tariffs for tax revenue – 30 per cent of net tax revenue was derived from import tariffs in 2001/2002. By contrast, the Chinese central government only raised around 7.4 per cent of its revenue from import duties in the period 1995-98 (IMF, 2002). The potential benefits for India of liberalising trade in manufactures are clear. Wood and Calandrino [52] estimate, using China as a benchmark, that were India to reduce its existing barriers to trade, especially to exports, to Chinese levels it could double its per capita income and increase exports five fold within two decades.

Tariff reform would be a lot easier to implement in India were it not for the size and continuing deterioration of the fiscal deficit. The Central Government's deficit has risen from 4.2 per cent of GDP in 1995/96 to 5.7 per cent of GDP in 2001/2002, while the overall public sector deficit (which includes the deficits of the Centre, of States, central public sector enterprises and the oil pool account) was 10.6 per cent of GDP in 2001/2002. The overall revenue deficit was estimated at 6.9 per cent of GDP in 2002/03 [53, p.16]. This is larger than the crisis level of 1991 and is projected to go higher still in 2003/04. Partly this is because agriculture and the services sector, which make up more than three-quarters of Indian GDP go virtually untaxed unlike in China.

FDI Flows

One of the major drivers behind China's trade expansion has been foreign direct investment (FDI) so that by 2000, China's stock of FDI as a percentage of GDP amounted to 32.3 per cent compared to India's stock equivalent to 4.1 per cent of GDP, [47].[vii] Even if allowance is made for some inflation of Chinese FDI statistics, and some estimates suggest the figures may be inflated by as much as 30-50 per cent by "round tripping", there can no doubt about the significance of foreign direct investment for Chinese economic performance (Table 2 and Figure 1).[viii] According to Tseng and Zebregs [45], FDI flows to China have raised annual GDP growth by nearly 3 percentage points per year during the 1990s. In 1992, foreign affiliates contributed 6 per cent of total industrial output, 20 per cent of exports and 6 per cent of tax revenues. By 2001, they were generating some 23 per cent of total industrial value added, 48 per cent of China's total exports and 18 per cent of tax revenues [32]. Significantly, reinvested earnings constituted nearly one third of total FDI inflows in 2000-2001.

India's FDI statistics, prepared by the Reserve Bank of India (RBI), until July 2003 only recorded flows in the form of foreign investors' direct equity investments.[ix] There has thus been significant downward bias in Indian FDI statistics. An International Finance Corporation (IFC) estimate suggests that India's actual FDI inflow in 2001 was between US$5 billion and US$8 billion.[x] The Planning Commission Report [40, p.16-17] argues that if allowance is made for round tripping of FDI in China and under-estimation in India, then China's FDI inflow/GDP ratio at 1.8 per cent is *only* double the adjusted FDI inflow/GDP ratio for India. The provisional estimates released by the RBI in July 2003 indicate that FDI flows to India stood at about 1.3 per cent of GDP in 2001/202 declining to 0.9 per cent in 2002/03 compared with 4 per cent of GDP to China [53, p.49]. When disparities in the per capita GDP of China and India are factored in the volume gap widens much further.[xi]

Overall then, India's performance in attracting FDI is still modest in aggregate. Aspects of the business environment continue to discourage FDI flows on a scale commensurate with the size of the Indian economy despite all the liberalisation efforts since 1991. Perhaps it is India's misfortune to reach the mid-point of reforming national business legal and regulatory infrastructure at the end of a period of rapid world economic growth. Many observers believe that there is still much that needs to be done. Acharya [1] cites the anti-export bias of foreign trade policies, the rigidity of labour laws, the policy of reservations for the small-scale industry sector, the weakness of infrastructure (especially power, ports, roads and railways) and slow and cumbersome administrative procedures (especially customs and excise) as factors contributing to a sluggish industrial economy. Wei [51] estimates that if India reduced its level of bureaucracy and corruption to Singaporean levels, it could expect FDI 348 per cent higher than present levels (and in China, if the authorities could do likewise, FDI would be 218 per cent higher than current levels). Clearly if Wei's estimates are reasonably accurate, China also has some way to go in improving its business environment to Singaporean standards.

Sources of FDI

Table 3 reports sources of FDI flows to India and China in 1999. The information has to be interpreted with a degree of caution. Firstly, country of origin is as declared to the authorities in each country yet much of the investment goes through a process of 'two-stage round-tripping' making it very difficult for the authorities to collect meaningful country of origin statistics. Investment, which can originate anywhere in the world (Europe, Japan, US, etc. including India and China), may first go through a registered company in an offshore tax haven such as the British Virgin Islands or the Cayman Islands. It then passes through a subsidiary registered in Mauritius (for India) or Hong Kong (for China) or direct into the country concerned. For example, Mehta [28] reports that Enron's Dabhol Power Company in Maharashtra was controlled through six different companies registered in various offshore locations. Indeed, UNCTAD [47, p.25] estimates that as much as 40 per cent of total FDI inflows into Hong Kong in 1998 was 'Hong Kong-tax haven routing' and the British Virgin Islands became the fourth largest source of FDI in China during 1999-2000. Meanwhile, Hong Kong's FDI in the mainland has apparently been decreasing since 1998.

A second source of difficulty in making comparisons is that the Reserve Bank of India only publishes statistics relating to country of origin of FDI by RBI approvals. The conversion rate of RBI approvals to actual investment varies from year to year but appears to be rising. In 2000 it was just under fifty per cent compared to a 1991-99 average of around one-third, although this may be a function of a slowdown in the number of applications to the RBI for approval of new projects [34][xii]. In China, the Ministry of Foreign Trade and Economic Co-operation (MOFTEC) compiles FDI statistics. MOFTEC statistics inevitably exaggerate the significance of Hong Kong as the ultimate source of foreign investment because of the much greater significance of 'round tripping' of domestic capital and what Zhan, [58] describes as 'transit FDI' from elsewhere through Hong Kong.

Looking at Table 3, it is clear that Hong Kong plays a very important role in the financing of FDI in China. Whether this is as a transit centre for FDI or as an independent centre for mobilising finance capital is much less clear-cut. Mauritius plays a more limited role in relation to FDI into India functioning essentially as a tax haven. This is because India's capital market is much more developed than that of China and India's foreign investment regime provides 'national treatment' to all investors. There are corporate income tax advantages established in 1982 for Mauritius-registered companies operating in India but these are not dependent on specific policy instruments of the Indian government. A second feature is the importance of European Union FDI for India and the Asian Pacific Rim countries for China. Japan and Korea are also becoming increasingly important for India. Both India and China receive significant volumes of FDI from the USA. However as noted above it is difficult to establish whether country of origin statistics merely reflect the changing tax advantages of offshore registration. As China extends its policy of "national treatment" of FDI as part of the WTO accession agreement it is expected that round tripping of domestic capital will have all but disappeared by 2005. This, of course, does not mean that foreign investors will stop seeking to minimise their global corporate tax rate through judicious use of tax havens.

Sectoral distribution

When the sectoral distribution of FDI is examined, major differences between the two countries are apparent. Between 1991 and 2000, a quarter of approved FDI in India was for power generation, 18.5 per cent for mobile phone companies, and electrical equipment - mainly software - attracted 10 per cent by value. Manufacturing attracted 12 per cent of FDI approvals and, within that total, labour intensive textiles received only 1.4 per cent of approvals. In China, the majority of FDI went into the manufacturing sector – 60 per cent of total contracted FDI –

while real estate attracted 24 per cent. Within the manufacturing sector, according to Tseng and Zebregs [45], half was directed towards labour-intensive manufacture (textiles and clothing, food processing, furniture).

What is striking about the statistics is the impact of government investment regimes on FDI sectoral flows. India opened up the power and telecommunications sector in the 1990s to FDI while China has only recently begun taking tentative steps to allow FDI in these sectors. By contrast, India maintained a policy of reserving real estate development and the textile industry up until 2000, before introducing a gradual process of liberalisation. The retail sector remains closed to FDI in India, while China began permitting international retail investment after 1992.

Sectoral trends suggest that China's policy of opening up the manufacturing sector virtually without reservation has been effective in attracting FDI to the sector to take advantage of the low unit cost of labour, while preceding cautiously with liberalising the service sector (telecommunications, power, retail and distribution and financial services). This cautiousness as exemplified by the policy of only granting licences to foreign investors in restricted sectors in designated cities, has been tempered by a willingness to ignore infractions of the FDI regulations by powerful municipalities when it has been thought politically expedient to do so.[xiii]

In India, the private sector is much more developed and politically active than in China. Liberalisation of FDI equity caps has tended to proceed first in central government-controlled infrastructure sectors where the authorities are manifestly unable to finance the requisite investment (power, telecommunications, transportation infrastructure and large-scale urban development). The policy of reserving industrial sub-sectors for small-scale industries (SSI) particularly textiles, garments and leather is taking a long time to roll back because of political opposition and the threat to the livelihoods of millions of small producers.[xiv] Unel's [49] analysis reveals that the productivity of Indian manufacturing after the 1991 reforms increased sharply in the chemical, metal, machinery and transport sectors, while productivity in all the traditional sectors remained static or declined. He suggests that it is no accident that the sectors experiencing significant productivity growth have also been subject to competition from imports and FDI.

The list of SSI reservations contained over 800 items in 1991 and still contained 674 in 2003, although as a concession to large-scale exporters, a license can be obtained for manufacturing SSI-reserved products provided all output is exported. Perhaps the most crippling element of SSI policy is the cap on investment by SSI firms at Rs. 10 million for 610 reserved categories and Rs. 50 million for 64 reserved items.[xv] This has stunted the natural growth path of successful domestic SSI sector firms and deterred expansion of domestic operations and venturing into exports. Of course, many Indian entrepreneurs have built up their operations by artificially sub-dividing business units to fit under the capital cap but this inevitably adds to business costs. It also inhibits subcontracting and joint venturing relationships with foreign partners because of the limit it puts on scale efficiencies in the SSI sectors.

Indian retailing remains totally protected from FDI apart from very limited franchising, because of fears of the political consequences of retail consolidation. As the Planning Commission Report on Foreign Direct Investment (August, 2002) observed; 'The retail sector in India is dispersed, widespread, labour intensive and disorganised. In the light of this it is not thought desirable to lift the ban on FDI in retail trade' [40, p.46].

By contrast with their Indian counterparts, local government officials in China are incentivised by the central government to expand the penetration of FDI at provincial and city level and across selected sectors. The incentive comes in two main forms. First, provincial and city governments are under considerable competitive pressure from the central government and their peers to produce FDI statistics that demonstrate they are expanding inward foreign investment year on year. For example, local government officials have been known to court potential investors by offering to lobby central government for a licence on their behalf. Foreign-owned banks and insurance companies are currently only granted full licenses to operate in a small number of major coastal cities. Yet behind the scenes, provincial governors and city mayors elsewhere are campaigning hard to gain licences for foreign financial institutions in anticipation of greater liberalisation that is part of China's WTO accession timetable.

Second, foreign invested enterprises (FIEs) are an important source of local tax revenue. Local government officials derive their authority directly from central government but have delegated powers to enact laws "according to concrete local conditions and actual needs". Because central government has increasingly devolved spending responsibilities to local governments, while reducing their share of central government revenues, they have had to raise business taxes to meet the shortfall[xvi].

Local officials have been forcing private Chinese businesses, since the beginning of the introduction of economic reforms after 1978, to make ad hoc contributions to local infrastructure and social development. Officials expect FIEs to behave in a similar way [7]. Local Chinese bureaucrats have both administrative and legislative power so local taxes are subject to negotiation within the "sprit of applicable law and the Constitution" and many of the regulations are intentionally vague. As a result local taxes are not imposed on all enterprises at a standard, centrally set rate but are administered on an informal quota system. This lack of transparency can give rise to corruption and complaints from investors. However the fierce competition for FDI at municipality level seems to keep the worst excesses under control. For example, the mayor of Chengdu, the provincial capital of Sichuan in western China, has a monthly meeting with all foreign investors in the city. Before the meeting officials from city hall routinely telephone investors to ask if they have any complaints to make about the business environment.

In India, there is sensitivity to political opposition from large-scale domestic business interests. This is hardly surprising given the high concentration of ownership in the private sector. Bardhan [6] estimates that in 1996, the top 50 Indian business houses controlled 44 per cent of private sector assets. The great majority of the most valuable companies are family businesses. For example, Harriss [19] reports that in Chennai, of the 31 companies represented in the list of the top 500 Indian companies only five are not family businesses, while seven belong to a single family group. Up until 1991 and the beginning of liberalisation, big business houses rarely faced much competition in the highly protected industrial economy, did not need to be customer-oriented and invested little in product development. Joint ventures with foreign companies could be used to reap monopoly profits in the domestic market. Since 1991, many of the big family-controlled business groups are in crisis as a result of growing competitive pressure from MNEs. Harris reports sharp declines in capitalisation of the big family groups relative to MNEs operating in India.[xvii]

Big business groups are well represented at the highest level by trade associations such as the Confederation of Indian Industries (CII) and the Federation of Indian Chambers of Commerce and Industry (FICCI). Many industrial groups have extensive connections with the political elite, some dating back to support for the independence movement. As Encarnation [15] observed in his pre-economic liberalisation study of Indian business houses, many maintained what he styles 'industrial embassies' in Delhi to co-ordinate lobbying efforts. Domestic small-scale business interests impact more directly through political parties at State level. The BJP, the leading party in the ruling coalition, is well known for its small business connections in many northern states. The democratic political process has continued to constrain the authorities' capacity to develop policies to capitalise on India's comparative advantage in labour-intensive manufacturing and repeal totemic policies dating back to pledges rooted in the struggle for independence [4].

The power of China's industrial oligarchs is of more recent vintage than in India. It was recently recognised by the election of the chief executive (CEO) of the Haier Group, Zhang Ruimin, to become an alternate member of the Chinese Communist Party Central Committee in 2002. Most Chinese CEOs direct diversified conglomerates with many business units: some units may be joint ventures with foreign partners, some may be partially privatised (up to a maximum free float of 35 per cent of equity), while other units may be entirely state or municipal government-owned. Overall ownership control of these often extremely complex conglomerates remains vested in the state or a local government authority. Thus representation of Chinese domestic industrial interests in the political system is exercised, if at all, directly through the state apparatus. Where protection and support is provided, it is dispensed through that apparatus, typically through favourable treatment in the allocation of state resources such as land or access to credit from state-owned banks or a light touch by the regulatory authorities. This process is usually opaque which is difficult for foreign investors to challenge and the outcome has only a tenuous connection with considerations of economic efficiency.

Geographical Distribution of FDI

The geographical distribution of FDI in China is notoriously skewed towards the coastal provinces and Shanghai and Beijing municipalities. According to the OECD [37], the coastal provinces plus Beijing accounting for 64 per cent of GDP, attracted nearly 88 per cent of total FDI inflows between 1983 and 1998, while the central provinces attracted 9 per cent (21 per cent of GDP) and Western China received only 3 per cent of FDI inflows (15 percent of GDP).

The central government's policy since the early 1980s has been to selectively channel investment into infrastructure in support of inward FDI promotion, initially in the coastal region, while at the same time experimenting with new policy instruments in a limited number of locations before adopting them more widely. The first step was taken in 1980 to establish four Special Economic Zones along the coast, which offered potential foreign investors significant tax holidays, low tax rates and flexible administrative arrangements. In 1984, 14 coastal cities were declared open foreign investment areas. Since then the central government has gradually devolved power to allow provincial governments and municipalities to establish a wide variety of different 'special' investment zones across the country to attract FDI. China now has 49 national zones, complemented by hundreds of export processing zones, development zones, industrial parks and science and technology zones at municipality level [46]. After 1996, the central government began to relax restrictions on access to the domestic market and started to implement a policy of "national treatment" for FDI that will be completed by 2005 as part of the WTO accession agreement. A concomitant of this policy of introducing "national treatment" for FDI is the phasing out of tax concessions.

The outstanding success of this strategy in the coastal region and resulting disparities in quality of infrastructure and distribution of FDI from east to west is also reflected in widely differing levels of economic development. The Ninth Five-Year Plan (1996-2000) committed the government to introduce measures to redress regional economic imbalances. The Western Regional Development Programme launched in 1997 explicitly recognised that the remarkable development of eastern China in the 1990s now permitted the central government to redistribute resources from the east to develop the west through heavy investment in human capital and physical infrastructure. The policy initiative to develop Western China was again reiterated in the Tenth Five-Year Plan (2001-5).

Work by Buckley et al. [8] confirms that the significance of the growth effect of both domestic and foreign investment increases from the western region of China to the coastal region. Furthermore the relative growth impact of FDI rises from west to east. In the less developed western region of China, domestic investment is of primary importance, while in the coastal provinces it is the interaction of domestic and foreign investment that produces growth-promoting effects. They conclude that FDI favours growth in the economically stronger provinces of China and those endowed with superior infrastructure. The contribution of domestic investment to growth is important at all levels of provincial development. Dayal-Gulati et al. [11] are less sanguine about the role of domestic investment pointing out that the loan-deposit ratio by province has a negative impact on growth. They interpret this relationship as reflecting state-owned banks being required to lend to inefficient state-owned enterprises. By comparison with coastal provinces, central and western provinces have a disproportionate share of state-owned enterprises in their economies as a result of state industry dispersal policies adopted in the 1960s and as a consequence of the overwhelming concentration of FDI in coastal provinces.

Graham and Wada [17] suggest a more finely nuanced view of foreign investment patterns in the coastal region. They distinguish between non-Japanese Asian-controlled FDI (owned by the ethnic Chinese diaspora from countries around the South China Sea) that is primarily concentrated in labour-intensive, export-oriented activities and FDI from Europe, Japan and North America which tends to be concentrated in more capital-intensive activities targeted at the domestic market. They conclude that while total factor productivity has accelerated in the coastal region relative to other regions, if China is to optimise the potential benefits from FDI it is necessary to differentiate between the policy regime for export-processing FDI and import-substituting FDI. In so far as export-oriented FDI in China is routinely tested in the global marketplace for competitiveness the policy regime may generally be assumed to be satisfactory. The more problematic policy regime is that operating in the import substitution sectors which is famously opaque and unequal in its treatment of investors once they have established themselves in China. This topic will be returned to below.

Unfortunately there is no comprehensive record of Indian FDI stocks or flows at state level so that it is not possible to carry out conventional statistical and econometric analysis of determinants.[xviii] However RBI statistics do provide information on the declared location of approved FDI by state. As in China distribution of FDI in India is also skewed. Some 45 per cent of approved new FDI investment by value between August 1991 and May 2002 was destined for four southern states of Maharashtra (17.4 per cent), Tamil Nadu (8.3 per cent), Karnataka (7.7 per cent), and Andhra Pradesh (4.7 per cent) and Gujarat on the west coast (6.6 per cent). Delhi attracted a further 12.2 per cent of approved FDI. Only 16 per cent went to the remaining states.[xix]

Ahluwalia [2] presents data to demonstrate rising regional inequality in India as measured by an increase in the inter-state Gini-coefficient from 1986-7 to 1997-98. The main driver behind differences in growth rate at state level is private investment, which has a strong and significant positive correlation with growth. Public investment and plan investment had no discernible impact on growth. The high growth states identified by Ahluwalia are, unsurprisingly, the states that have been most successful in attracting FDI (with the exception of West Bengal, which paradoxically has experienced agriculture driven growth and private industrial capital flight).

Unlike in China there is no central government policy in India to direct infrastructure investment in favour of particular states or regions in order to promote inward FDI, though at central government level there is a general budgetary redistribution mechanism that operates between the wealthier and poorer states. Since the economic liberalisation programme began in 1991, the power to attract FDI has been devolved to states. This has been taken up with varying degrees of energy and success.

In 1997, the World Bank [55] could write enthusiastically about the complementarity of state-level development spending in support of attracting private capital investment. By 2003, the situation had deteriorated significantly. Revenue deficits have averaged more than 6 per cent of GDP over the last six years reflecting falling revenues and rising expenditures on interest payment, subsidies, civil services salaries and pensions. This has inevitably crowded out development spending. High real interest rates necessary to sustain the funding of rising government debt have also constrained private investment. Indian banks in 2003 had one of the highest ratios of government debt to deposits in the world [53, p. v].

In this situation, state governments find they have very limited capacity to fund the quality of physical infrastructure necessary to attract large volumes of FDI even though there is evidence of strong positive complementarities between public investment in infrastructure and private investment. For example, Oman [38] cites a study by Venkatsen of the correlation between the incentives offered by states and their ability to attract FDI, which concludes that the major determinant of investors' decisions in India is the availability of good quality infrastructure. A state's provision of incentives can "play a significant role in attracting private investment if, and only if, the state has a certain level of infrastructure available to support investors' activities"(p.46).

Despite the fact that India was a pioneer in creating one of the world's first export processing zones (EPZs) at Kandla in 1965, they have never had much impact on India's export performance. Tariff exemption schemes have tended to be excessively complex and encourage a 'licence raj' mentality at the operational level. The Central Government introduced a policy promoting fifteen Agricultural Export Zones (AEZs) and the enhancement of Special Economic Zones (SEZs) in April 2000.

Unlike the previous EPZ policy and reflecting the current reality of acute shortage of development funds, the private sector is expected to play the lead development role in the zones.

Work by Lall et al.[25], on the economic geography of industry location in India, concludes that the local presence of a mix of industries at district level is the only economic geography variable that has a significant, consistent and substantial positive effect for firms. This factor is significant for all sizes and sectors of manufacturing industry. The implication of this finding for India is clear. With the very modest public investment in industrial infrastructure that is possible given the size of current budgetary deficits, industrial growth is likely to continue to occur where a diverse manufacturing base has already become established, and where all kinds of private investment – foreign and domestic – is growing vigorously. This in turn is likely to have a positive impact on state-level capacity to invest in infrastructure, both because of the positive impact of growth on state revenues, and because various forms of private-public funding partnerships to develop infrastructure are likely to become more feasible. Nevertheless, any improvements in infrastructure investment are likely to be modest in comparison with, for example, even 'remote' western Chinese provinces such as Sichuan, which in 2001 alone invested US$ 20 billion in infrastructure. Sichuan's GDP is ranked tenth in China.

The critical importance of efficient physical infrastructure was recognised early on in the 1980s in the process of establishing special economic zones (SEZs) in the coastal region of China for foreign, export-oriented investors. By contrast in India, the share of infrastructure in fixed capital formation has declined sharply for nearly one and a half decades, [34], p. 1709.

Business climates compared

One of the paradoxes of India's FDI policy regime is that few restrictions apply to foreign-owned enterprises that do not apply to Indian-owned entities, yet the perception remains that business activity is over regulated and foreign investors are viewed with some suspicion, [40], pp.21-3. Apart from equity limits on a relatively small number of sectors, India extends National Treatment to foreign investors and so there is no specific statute to regulate foreign direct investment [57], p.22. However, it is a common complaint effectively orchestrated by organisations such as the Confederation of Indian Industries (CII) that one of the major barriers to investment in India, domestic or foreign, is excessive regulation of entry and exit. In surveys carried out by the World Bank Group, of a sample of firms in India and China [54 and 56], it was found that it takes 10 permits compared to 6 in China, and 90 days in India relative to 30 days in China, to start up a new business (see Table 5). [xx] When it came to a foreign-invested power plant in India, the survey [56] reports that it took 43 clearances at the central government level and 57 at the state level.[xxi] LaFarge apparently required 75 permissions to take over an existing cement business.

Widespread criticism of the Indian licensing system for business start-ups has sparked off reform in many states where the introduction of the so-called single window system of investment approval has been adopted and seems to be working well. For example both Tamil Nadu and Andhra Pradesh have adopted such a scheme and actively proclaim the involvement of the Chief Minister in monitoring the progress of large projects (more than Rs. 25 crores[xxii]). The Chief Secretary is responsible for tracking even quite modest new investment proposals (up to Rs. 25 crores). The state government of Orissa is committed to introducing a single window system in its new Industrial Policy [16], paragraph 5 and 6.

Once the deal has been done and the investor attempts to open for business in India, the 'inspector raj' is liable to move into action. While this may be a minor irritant for a large international company with good political connections, the management time that has to be devoted to dealing with an endless stream of inspectors can be a significant cost burden for smaller companies. The World Bank surveys estimate that in India it takes on average 16 per cent of senior manager's time to deal with government officials compared with 9.9 per cent of management time in China. Foreign investors do not seem to find this as burdensome as domestic investors because they rely on their local joint venture partners to deal with these intrusions or, in the case of a wholly-foreign owned subsidiary, a specially selected local manager to liase with officials. Nevertheless interview data suggest that foreign investors are also annoyed by visits from too many inspectors from different government department making surprise inspections and sometimes pulling up management on frivolous grounds. In its worst form, it is often little more than blatant 'rent collecting'.

Conclusions

The Indian authorities are beginning to actively promote an investor-friendly policy stance to the outside world. This rather belated policy response is driven by concern for the sustainability of growth rates of sufficient magnitude to lower poverty rates. When current levels of GDP growth of 5-6 per cent per annum are combined with a population growth rate of 1.8 per cent per annum, the Planning Commission estimates poverty will begin to increase, that is unless real GDP growth rises above 7-8 per cent per annum. Facing a government budget deficit of over 10 per cent of GDP, the authorities have very limited capacity to invest in growth. Additional growth can only come from increased private foreign and domestic investment. Unfortunately, private domestic investment is being squeezed by the government's high interest rate policy necessary to fund the budget deficit. This is forcing the authorities to look towards foreign direct investors. India's previous economic policy tradition of *swadeshi* (self-reliance) adopted after Independence in 1947 does not fit easily with current economic realities. Vested political interests continue to fight a rearguard action against the expansion of FDI in India. This is forcing the Union Government to proceed with extreme caution in opening up the Indian economy to FDI.

The best prospects for significant growth of FDI is occurring at state level where local accommodation to the realities of economic development is much easier in some states than others. For example, Andhra Pradesh, Tamil Nadu and Karnataka have been very successful in attracting FDI, particularly into the IT sector, by judicious investment in appropriate infrastructure and focused investment promotion and support activity through the state political and administrative system. The situation in traditional manufacturing is also beginning to improve but as indicated above many barriers to growth of FDI remain.

Whether India can catch up with China in terms of GDP growth rate, share of world trade or FDI seems rather problematic. However, in 1982, when China first began to actively seek FDI few would have expected it to be playing host to over $400 billion of FDI by 2002. Chinese infrastructure was then very backward and the authorities were still deeply suspicious of foreign investors. Few were certain that China would never return to the autarky of the past. Through a process of policy experimentation and encouraging economic devolution to provincial and municipal level, the authorities developed a mutually reinforcing system of incentives for state bureaucrats and foreign investors. Opposition to economic liberalisation was dealt with by sharing the benefits first with the urban population of the coastal provinces and then some 150 million economic migrants from the interior as growth accelerated in the 1990s.

India needs to further open up its economy to trade and foreign investment so the benefits of growth extend beyond the urban middle class beneficiaries of India's world class software and IT industries and beyond the highly protected workers in traditional manufacturing industry. Reform has to be seen to work at state and district level and this requires political leadership to drive an efficient state-level bureaucracy. There are a few Chief Ministers in India today who are providing that leadership. It remains to be seen whether their example becomes the dominant role model or whether caste-based politics focused on dividing up public sector jobs amongst supporters takes over from pragmatic pursuit of economic growth as the priority

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Contact the author for a list of references.

End Notes

[i] For example, [43] argues that the effect of FDI on economic growth tends to be weak or even that much of the superior economic performance is driven by favourable domestic factors to which foreign investors respond.
[ii] [3] estimate the share of explained variance accounted for by their globalisation measure as 60 per cent for developing countries and 78 per cent for industrial countries.
[iii] The extent to which new products and technology are introduced is related to the motive behind FDI. Where there is only limited competition and the motive behind FDI is primarily market-seeking then the incentive for technology transfer is likely to be lower.
[iv] Indian industrial products amounted to 0.55 per cent of world exports in 2002/3 up from 0.5 per cent in 1990/91 [53].
[v] The average collected tariff rate was 21 per cent in 2000/01 down from 31 per cent in 1996/7. The collected tariff rate does not bear any direct relationship with the "marginal" tariff rate, which may even deter all imports under a particular category. It does include various exemptions. As a consequence collected rates do not reliably capture the distorting effects of the overall tariff structure.
[vi] China has already announced that its import duties are expected to average 9 per cent by 2005.
[vii] If flows of FDI are considered the gap between China and India narrows. According to UNCTAD, FDI as a percentage of gross fixed capital formation was 2.4 per cent for India and 11.3 per cent for China in 1999. It should be noted that FDI flow statistics are much more prone to volatility than stock statistics.
[viii] Wei [51] estimates that China's FDI stock figures should be reduced by 60 per cent and flows by 50 per cent, to take account of the Hong Kong effect and "round tripping".
[ix] Until July 2003, the RBI did not follow the standard IMF definition and excluded reinvested earnings, royalty payments, inter-company debt transactions and commercial borrowing by foreign direct investors. For example, BG plc announced in 2002 investments of £500 million in the oil and gas sector using loan financing but this investment would not have appeared in the Reserve Bank of India's FDI statistics. The equity capital of unincorporated entities such as foreign bank branches were also excluded.
[x] Estimate attributed to Guy Pfeffermann, Chief Economist of the IFC, in the Planning Commission FDI Report [40, p.16].
[xi] India's GDP per capita was $467 and China's was $855 in 2000, [45].
[xii] As Nagaraj [34] observes, 'Apparently, even the concerned official agency does not seem to know - let alone monitor - how actual inflows are translated in capital formation, transfer of assets or change in managerial control' (p. 1702).
[xiii] For example, in 1992, China agreed to allow FDI in retailing in 14 designated cities but by the late 1990s city authorities were openly flouting the regulations in a dash to attract FDI to the sector [5].
[xiv] For example, it is estimated that there are 12 million handloom weavers working in the State of Andhra Pradesh whose livelihoods would be put at risk if the weaving sector were fully opened to investment in integrated textile mills and a non-discriminatory tax regime for domestic and foreign investment.
[xv] US$1 = Rs. 47.3 as at May 2003.

[xvi] Blackman [7] reports that in the early 1980s expenditure by local governments was about equal to that of central government. By 2000, local government was spending at more than twice the central government rate and yet its share of central government revenue had fallen from 67 per cent to 50 per cent.
[xvii] Khanna and Palepu [24] suggest that the performance of Indian business groups initially declines with group diversification and subsequently increases once group diversification exceeds a certain level. Affiliates of the most diversified business groups outperform unaffiliated firms.

[xviii] Some might argue that the lack of visibility of FDI in state-level economic statistics reflects a deep-rooted ambivalence. However there is a general absence of reliable data at state level covering both domestic private and foreign investment. The Centre for Monitoring the Indian Economy (CMIE) does maintain a capex database but that has a number of weaknesses (see [2], pp. 11-12.).
[xix] 26.8 per cent of approved FDI is not allocated to particular states in official statistics though it seems reasonable to assume a similar geographical distribution to that for FDI where location is declared. (http://iic.nic.in/iic2_c03.htm)
[xx] Both the India and China studies are based on surveys of firms located in state or provincial capitals, ten in Indian states and five in Chinese provinces. There is no distinction made between foreign and domestic firms in the Indian sample.
[xxi] A more charitable interpretation of the licensing requirements for power plants might be that the authorities are trying hard to avoid the mistakes made over the Enron investment in the Dhabol power plant in Maharashtra which had a damaging impact on India's reputation as an FDI destination.
[xxii] Rs. 25 crores is approximately US$5 million.

Corruption, Trade and Foreign Direct Investment

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Abstract

The paper examines the effects of corruption on import, export and foreign direct investment (FDI). Countries are usually keen on attracting FDI for economic development. However, corruption can raise operational (and strategic) concerns for potential investors and sway their decision in favor of a less corrupt country over a more corrupt country. With regard to exporting to a country, corruption-induced operational issues can also have a similar effect. Importing from a country that is corrupt can lead to questions regarding overall productivity and commitment to product quality, delivery schedules, etc. Importers may view this as problematic if it starts affecting their relationships with distributors, wholesalers and retailers. The findings confirmed a negative relationship in all three cases. Corruption affected import and FDI the most followed by export. The existence of a high level of corruption in a country will hurt its chances of competing in the global market place. Policy makers in these countries must address the issue of corruption and attempt to allay the concerns of international companies and investors alike. The fact that corruption does not equally affect different modes of international business operations offers an important insight into the managerial decisions.

Introduction

Corruption is an endemic disease distorting international business. While not always illegal; corrupt acts reflect improbity—the breakup of sound, virtuous rules, and procedures applicable to social and economic life. It can take on different forms. While bribery and extortion can be the most common, such manifestations as dishonesty, misrepresentation, reneging on the commitments, passing on confidential information, nepotism, cronyism belong to the same category. Corruption manifests itself in the "petty" format but also reaches big dimensions—individual cases where large amounts of money are involved. It can be associated with mere "grease" activities aimed at easing the burden of bureaucracy as well as with operations that break the law. Corruption may occur at the points of contact between public administration and business and thus relate to the nature of regulatory environment, authorization procedures and the degree of public scrutiny. But corrupt practices thrive within the business world as well. All the facets of corruption make transacting international business more cumbersome, confusing and, ultimately, less efficient. The only beneficiaries are unscrupulous individuals or groups, who due to their position of control and power are able to extract private rents in the shadow of actual contracts. [1, 2, & 3]

Unfortunately, despite the resolutions by the international organizations such as the United Nations, the OECD, the International Chamber of Commerce and good will demonstrated by many MNCs in their codes of conduct, the malaise persists. Transparency International has been monitoring corruption since 1995 and the number of countries for which the corresponding indices have deteriorated does exceed the scores of nations where the indices improved. [4]

Literature Review and Hypotheses

The impact of corruption per se on international business did not emerge as a separate topic for empirical studies until the early 90-ties of the past century. Earlier, corruption was implicitly lumped together with other factors in the composite index of political stability. Following theoretical arguments pointing to the damage corruption inflicts on the economy; several studies looked at the impact of corruption on the inflows of foreign direct investment. [5] Findings corroborated the assumption that corruption is a detriment to FDI and hence a liability to the host economy. [6, 7, 8, & 9]

While it can be posited that corruption can also adversely affect the international trade (exports and imports), the subject has been hardly studied. The scarce empirical work published underscored a generally negative impact on trade. [10] Lambsdorff offers a more nuance approach in that out of the 19 exporting countries studied by him, some respond in relative terms better to corruption than others do. [11] The specification of his model –relative shares—does not allow for testing the overall impact of corruption on exports.

We believe that it is inconceivable to expect that corruption would across a wide array of cases prove an incentive to international business contracts regardless of its format. As a matter of fact we posit the opposite is true: corruption discourages international business transactions. Hence, the present work attempts to test the following hypotheses:

Hypothesis 1. Imports from the country of origin to the world are negatively affected by the level of corruption in that country.

Hypothesis 2. Exports from the world to the destination country are negatively affected by the level of corruption in that country.

Hypothesis 3. Foreign Direct Investment from the world to the host country is negatively affected by the level of corruption in that country.

At the same time, it seems logical that the adverse effects of corruption are the function of the riskiness of the type of the transaction itself. Hence we propose the following hierarchy:

1. FDI as the most complex and long term business commitment is by its nature and the capital involved the riskiest of international contracts—in any event certainly riskier than the export-import transactions. [12]
2. Import transaction is riskier (for the importer) than exporting. It involves much conditionality such as the quality of goods/services ordered, timely delivery, adequate insurance coverage, handling the warranty, maintenance and service. In a corrupt environment, all of these become a cause for potential problems with additional costs to resolve them. As far as exporting to the country characterized by corruption is concerned, the above concerns are handled in the country of the exporter and not directly affected by the characteristics of the importing country. Compared to the import transaction, exporting involves two additional concerns: 1/ securing payments, 2/ obtaining the import license (whenever applicable). Any problems in those areas with corrupt partner or respective administration may act as a deterrent. However, they can be alleviated when shifted upon other parties: financial institutions, the importing company itself. After all, the license needs to be obtained **prior** to the shipment of goods and the payment against the documents can be effected by the banks. Finally, in the buyer's market, the exporter needs to be prepared to accept higher risks while eventually attempting to beef up the price accordingly. Also, ever since Transparency International started compiling the Bribe Payers Index there is evidence of exporters using the tools of corruption to their advantage. [13] Except for sporadic cases of bribes paid to obtain contracts for limited raw materials, far less documentation exists with respect to the importers.

The above considerations lead us to formulation of the following two hypotheses:

Hypothesis 4. Corruption is a relatively stronger deterrent to FDI than to the international trade.

Hypothesis 5. Corruption is a relatively stronger deterrent to imports from a corrupt country than to the exports to such country.

Methodology

The sample of countries is chosen from the International Financial Statistics data set published by the International Monetary Fund (IMF). The data set is an annual publication. The country-specific data are updated regularly but usually lags a year or two due to the enormity of the task. Five years of data covering the period 1996-2000 is chosen for the study. This ensured fairly recent and comprehensive data for 89 countries. These countries represent a wide spectrum covering the developed, developing and transition economies of the world.

Trying to measure corruption is a serious challenge. First, objective measures are hard to come by and do not always fully capture the corruption phenomenon. For example, the magnitude and the frequency of corruption are not always found and presented in a single variable. Also, given that there are different forms of corruption, bribe and otherwise, it is difficult to find one source of data that can represent the whole range of corruption. These problems have reduced the application of objective measures in empirical studies.

Subjective measures have become a good alternative for researchers to analyze corruption. Questionnaire-based surveys are widely used for corruption. Transparency International (TI), the non-profit organization which vows to fight corruption worldwide, publishes the Corruption Perception Index (CPI) for countries around the world. This index is updated annually and is proven to be a reliable indicator of corruption. Its validity has been established when researchers found a high positive correlation between it and other subjective corruption measures. [14] The CPI index ranks countries on a 0 to 10 scale, with ten being the least corrupt. It has been used extensively by researchers and is adopted as the corruption variable in this study as well. For further details and a critique of the measure, see Husted. [15]

Data on country specific FDI are collected from the UNCTAD Foreign Direct Investment Online and measured in the US dollars (billion). [16] FDI is the annual inflow of foreign direct investment to the host country. Data on Import and Export are also collected from the International Financial Statistics Yearbook. Data for import, export and FDI are reported in US dollars (billion). Log transformation of all three variables are done and used in the analysis to make the distributions nearly normal and the error term homoscedastic.

Based on the international business literature, there are several macro determinants of foreign direct investment and trade. These macro factors are incorporated in the analytical model to extract the specific effects of corruption on trade and investment. A brief discussion of these factors is presented here. FDI and trade are positively influenced by the size of the host country's economy as measured by its population or GDP. [17, 18, 19, 20, & 21] For this study, country size is measured as the log of population. [22] GDP per capita is another significant explanatory variable for FDI and import representing the purchasing power of the host country. [23, 24] Log of GDP per capita is used here as a measure of a country's purchasing power.

Country-level unemployment figures have been considered a proxy for labor availability. [25] Under high unemployment, workers value their current job higher and are willing to accept lower wages to keep the jobs. Thus, a high unemployment would positively affect FDI. The same argument will also positively affect export from the target country. The unemployment data (percentage of population unemployed) is collected from the International Labor Organization. [26]

It has been shown that the duration of diplomatic and economic ties between the home and host country increases the likelihood of FDI. Greater interactions should promote understanding between the home and host country that is conducive to trade and FDI. Economic ties reflecting the home and the host country participation in the same common market areas (EU, MERCOSUR, NAFTA, and ASEAN) are included as a (dummy) variable in this study. Data was collected from the official membership lists of the regional blocs.

Geographic distance affects trade and FDI. Geographic proximity exerts a multifaceted impact, facilitating contact with target country and reducing the transportation costs. Also, in case of large geographic distance, the transportation costs encourage substitution of exports by market-oriented FDI. [27] The three prominent centers of trade and investment, USA, Western Europe and China are used to measure geographic distance. Three distance variables are included in this study. They are the distances between the target country and the USA, France (a middle point for Western Europe), and China respectively. The distances were obtained from Hengeveld. [28]

Finally, the presence of the corporate watchdogs in the host country is included as a variable affecting trade and FDI. It is expected that the presence of organizations such as Transparency International (TI) will improve the overall business and investment climate. Representation of TI in the host country was included as a dummy variable in the study. [29]

The five-year, cross-sectional data on 89 countries are pooled together for statistical analysis. A maximum of 445 observations for the variables was expected applying this method. However, missing values related to a country or a particular year resulted in less total observation for analysis.

An OLS (ordinary least squares) multiple regression model is adopted for the analysis since continuous variables are used in the study. A test conducted for multicollinearity among independent variables using the variance-inflation factor (VIF) did not suggest any serious problem. Table 1 reports the correlation coefficients.

Results

Three separate regression analyses are done for the three dependent variables. The dependent variables are log Import, log Export, and log FDI. The independent variables for all three regressions are the same. This provided an opportunity to compare the effect of corruption and other independent variables across the three models. Table 2 shows the results of the regression analyses. In column one the findings for the dependent variable log Import is shown. Column two shows the findings for the dependent variable log Export. And finally, in column three, the log FDI results are reported.

For log Import, the overall model is highly significant (F=146.87, p<.001). The adjusted R-square is 0.87, which is very high suggesting that the independent variables explain most of the variance in the dependent variable. The log Export model also is statistically highly significant (F=204.09, p<.001) with an adjusted R-square of above 0.90. Again, this suggests a good explanatory power. The last model, with log FDI as the dependent variable, is statistically significant too (F=39.28, p<.001). The adjusted R-square is not as high as the other two models but is quite good (0.64).

In all three models, the corruption variable CPI is statistically significant (at the p<.01 level or higher). This supports hypotheses 1, 2 and 3. Corruption negatively affects the FDI inflow as well as import to and export from a country. In addition, the findings further point to a difference in the magnitude of the impact of corruption across the three dependent variables. Looking at the standardized coefficients of corruption in the three regression models, it can be concluded that the impact of corruption is the highest for import (coefficient =0.233) and FDI (coefficient=0.228) followed by export (coefficient = 0.190). The findings that FDI is more influenced by corruption than export, partially supports hypothesis 4. The stronger effect of corruption on import than exports supports hypothesis 5.

Besides corruption some other independent variables showed significant results. As expected, market size (log population) and purchasing power (log GDP/capita) positively affected trade and FDI. These two variables are

TABLE 1
CORRELATION MATRIX

Variable	N	1	2	3	4	5	6	7	8	9	10	11
1. Log Export	423											
2. Log Import	417	.981**										
3. Log FDI	427	.797**	.812**									
4. Log Population	442	.533**	.547**	.476**								
5. Log GDP/Capita	341	.550**	.548**	.583**	-.178**							
6. CPI	370	.506**	.502**	.441**	-.280**	.771**						
7. Unemployment Rate	266	-.114	-.116	-.082	-.017	-.176**	-.176**					
8. Distance from USA	440	-.094	-.107*	-.222**	.125**	-.177**	-.171**	-.187**				
9. Distance from China	440	-.214**	-.245**	-.055	-.119*	-.139*	-.112*	.351**	-.371**			
10. Distance from France	440	-.110*	-.131**	-.107*	.149**	-.233**	-.199**	-.131*	.330**	.347**		
11. Economic Ties	445	.586**	.599**	.504**	.233**	.393**	.400**	.031	-.084	.038	-.060	
12. TI Chapters	445	.052	.084	.101*	.016	.148**	.017	.077	-.001	-.034	-.165**	.055

* p < .05 , ** p < .01

well established in the literature and this study is no exception. Geographic distance from China is the only distance variable of the three which is statistically significant and in the right direction. Distance (from China) negatively affected trade and FDI. However, given that the other two distance variables failed to show significance, not much should be made of this finding. Economic ties showed positive significant results for both import and export but not for FDI. Trade, it seems is influenced by regional cooperation and economic development. FDI motives, on the other hand, seem to be far more complex and not bounded by regional economic agreements. Actually, it has been long emphasized in the literature that FDI is an instrument to overcome the investors' disadvantage of being from outside the regional economic blocs—the so called "tariff jumping." This factor might still play a role. Finally, the TI Chapter variable is shown to be significant for trade and FDI. A corporate watchdog such as the TI has a positive impact on businesses in general.

TABLE 2
OLS REGRESSION RESULTS

	Log Import (From Target Country)	**Log Export (To Target Country)**	**Log FDI (In Target Country)**
Log Population	0.701*** (0.036)	0.727*** (0.029)	0.676*** (0.067)
Log GDP/Capita	0.415*** (0.059)	0.428*** (0.047)	0.369*** (0.118)
CPI	0.233*** (0.032)	0.190*** (0.025)	0.228** (0.064)
Unemployment Rate	- 0.023 (0.012)	- 0.039 (0.009)	- 0.053 (0.022)
Distance from USA	0.019 (0.000)	- 0.005 (0.000)	- 0.046 (0.000)
Distance from France	- 0.016 (0.000)	- 0.033 (0.000)	- 0.030 (0.000)
Distance from China	- 0.158*** (0.000)	- 0.151*** (0.000)	0.118† (0.000)
Economic Ties	0.146*** (0.106)	0.137*** (0.085)	0.066 (0.201)
TI Chapter	0.061* (0.100)	0.085*** (0.079)	0.102* (0.189)
Adjusted R^2	0.870	0.902	0.640
F	146.87***	204.09***	39.28***
N	196	198	194

Standardized regression coefficients are reported; standard errors are in parenthesis

† $p < 0.10$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Discussion and Conclusion

This study tested corruption's impact on trade and FDI. The large number of countries in the sample provided diversity to generalize the relationships found. Specifically, the findings show that corruption in the target country negatively affects FDI. The higher the level of corruption is, the less the FDI coming into the country. Similar relationship exists for exporting and corruption. Countries targeted for export can expect less if the corruption level is high. Exporters do not view these countries favorably and would like to stay away from the hassles of dealing in a corrupt environment.

Also, the magnitude of the corruption coefficient for FDI is higher than the corruption coefficient for exporting. This implies that, ceteris paribus, the impact of corruption on FDI is greater that that on exporting. Companies from home countries view FDI as an entry mode requiring greater level of commitment and investment than exporting. This increased level of involvement translates into a higher level of risk (and uncertainty) for the concerned companies. As a result, various effects of corruption on strategic and operational decision making are taken much more seriously in case of FDI than exporting. For exporting, in comparative terms, there is less need for direct control. Once the goods reach the target country it is usually the importer's or an agent's responsibility. This typically relieves the exporter from further involvement. Also, exporting as an entry mode provides more flexibility (in strategic and operational matters) than FDI. Given that it requires less overall investment in the target country, a need to change can be made relatively easily. Exporting companies can adjust their market focus according to the corruption level of the target countries and in extreme situations can completely pull out of a highly corrupt country. Such decisions are much more difficult for companies involved in FDI. Also, our results suggest that dealing with corruption is an easier and less costly a task for the exporters than for the foreign investors. Considering that (some) exporters do offer bribes, it follows that doing the same regarding FDI is a more complex and cumbersome job. [30]

The study also tested corruption and its impact on importing from a target country. The results confirmed a negative effect between the two. Companies interested in importing from a target country are cautious about the corruption level that exist there because they want to ensure consistency with respect to the quality, pricing, delivery and other terms for the goods and services. Without having any direct control over the individuals and companies in the target country, it is quite difficult for importers to maintain standards for goods and services. A corrupt environment which raises the uncertainty level for importers and makes it difficult to pursue legal recourse or any other action (short of canceling the order and taking a hit) is a matter of serious concern. Companies are careful in pursuing any kind of importing relationship with a corrupt target country. A related finding in our study is that the magnitude of the corruption coefficient for importing is higher than the corruption coefficients for exporting and FDI. It seems that companies when buying from a country are far more concerned about the corruption and its impact than when they are selling or investing in that country. The fact that being on the one side of trade relation than on the other affects the sensitivity to corruption needs to be further explored and empirically tested.

The findings of this study have obvious implications for policy makers in the target country. At a minimum, policy makers in charge of developing trade and investment must understand the debilitating effect of corruption on the country's prospect. Business dealings can only flourish in a transparent and open market where the rules of the law are firmly established and trust can take hold. Corruption can destroy any hopes of building trust among business partners and the lack of proper regulatory institutions can further discourage potential investors. Policy makers must take strong measures against corruption. The development of trade processing zones with special procedures to combat unintended interference and corruption can be a fruitful approach. Providing incentives to rule enforcers for getting rid of corruption can be another option. At the country level, developing a good international image for business is essential to attract new partners and investors. Above all, strong leadership that can set good ethical standards is crucial in this respect.

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Modeling Volatility and Forecasting the Mexican Stock Market Price Index

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Abstract

ARCH models have become increasingly popular on financial literature. This paper shows a study of performance of some ARCH models. First an AR model, allowing to accommodate time-varying volatility through ARCH effects, is used to capture the main stochastic features of historical returns of the Mexican Stock Exchange with two third of data in our sample. The time-varying volatility is accommodated by GARCH (1,1), TARCH(1,1), and EGARCH(1,1) models. Then a k-step forecast of the Mexican Stock Index is conducted with the remaining data. We find all the ARCH models succesful on reproducing the features of the index prices probability distribution. We conclude that models accommodating time varying volatility are a promising field of research.

I. Introduction

Is widely known that financial markets time series exhibit some stylized facts such as clusters of volatility, leptokurtosis, and "leverage effect". The clusters of volatility suggest significant temporal correlation of the volatility, i.e., the volatility observed on time t depends on volatility on time t-i. Leptokurtosis implies departures of the normal distribution that alters the probability density, in such a way that extreme values are observed with a higher frequency than that corresponding to a gaussian distribution. On the other hand, by the leverage effect, in financial markets is observed that a negative shock produces a higher level of volatility and a more pronounced fall in returns that the level of volatility and rise of returns when a positive shock occurs.

The ARCH model, introduced by Engle in 1982, was designed to model a process exhibing autorregresive conditional heteroskedasticity, so being an *ad hoc* mean to deal with the temporal dependence observed in the volatility of many assets returns. Nevertheless, as pointed by Peters [2001], a high-order ARCH model is required to capture the volatility's dynamic. To solve this, in 1986 Bollerslev introduced the generalized ARCH (GARCH) model. Despite the capability of ARCH and GARCH models to cope with the heteroskedasticity and leptokurtosis, both fail to capture the leverage effect, so, other models of conditional volatility were introduced, e.g., the Treshold ARCH (TARCH) and the exponential GARCH (EGARCH). This is not a exhaustive list, but only a sample of the several models included in the ARCH family.

The purpose of this paper is to present our first step on the evaluation of the capability of ARCH models to capture the main stochastic features of the volatility present in the returns of the Mexican stock market, and their usefulness to forecast the level of the main price index of this market.

This paper is organized as follows. In section II a conceptual model of the supposed data generating process is presented. Section III deals with the empirical study and shows the modeling results. Section IV concludes.

II. The Model

Assume that the price of an asset follows the discret process $P_t\ ?\ P_0 e^{?r_t\,,?\,t?}$, ? ?1; with a changing rate of growth, i.e., be the rate of return, r_t, a function of time. So, the relevant information available to any market agent is the set of past realizations of the process, and the conditional expected value of the rate of return can be expressed as $E[r_t \mid ?_{t-1}] = ?_t$, whose conditional variance is $E[(r_t - ?_t)^2 \mid ?_{t-1}] = ?^2_t$.

Some financial modelists represent the rate of growth as stochastic processes, sometimes with a member of the familiy of stationary ARMA models. If this is the case, the rate of return is made to depend on its past values and, or, the past forecast errors; i.e., r_t = $?_t + ?_t$, $?_t\ ?\ ?_0\ ?\ \sum_{i?1}^{p} ?_i r_{t?i}\ ?\ \sum_{j?1}^{q} ?_i ?_{t?j}$, p,q ? 0??As a result, $?_t^2$ = Var(r_t | $?_{t-1}$) = Var($?_t$ | $?_{t-1}$).

Turning the attention on the dynamics for one period, making ? t = 1, and taking natural logs in the original expression for the assumed process generating the prices data, we can obtain logP_t–logP_{t-1}= $?_0\ ?\ \sum_{i?1}^{p} ?_i r_{t?i}\ ?\ \sum_{j?1}^{q} ?_i ?_{t?j}\ ?\ ?_t$.

Under an ARCH process, we have $?_t$ = $?_t ?_t$, and $?_t^2\ ?\ ?_0\ ?\ ?_1 ?_{t?1}^2\ ??\ \ ??_m ?_{t?m}^2$, $?_0$?? ?, $?_I$?? ???I=1,2,…,m, and {$?_t$}?iid(0,1). The GARCH model of volatility is $?_t^2\ ?\ ?_0\ ?\ \sum_{i?1}^{m} ?_i ?_{t?i}^2\ ?\ \sum_{j?1}^{s} ?_j ?_{t?j}^2$, the effect of past volatility also accounts for the present volatility, not only the past shocks as in a ARCH model. Furthermore, now is required $?_0$?? ???$_I$?? ???$_j$?? ??and $\sum_{i?1}^{\max(m,s)} (?_i\ ?\ ?_i)\ ?\ 1$.

The ARCH asymmetric models allow for accommodating the asymmetry in volatility induced by the stronger effects of negative shocks (“the leverage effect”). For instance, Tarch model is $?_t^2\ ?\ ?_0\ ?\ \sum_{i?1}^{m} ?_i ?_{t?i}^2\ ?\ \sum_{i?1}^{m} ?_i ?_{t?i}^2 d_{t?i}\ ?\ \sum_{j?1}^{s} ?_j ?_{t?j}^2$, where d_{t-I} is a dummy variable equals 1 if $?_{t-I} < 0$, and 0 otherwise. The EGARCH model is $\log ?_t^2\ ?\ ?_0\ ?\ \sum_{i?1}^{m} ?_i \left|\frac{?_{t?i}}{?_{t?i}}\right|\ ?\ ?_i \frac{?_{t?i}}{?_{t?i}}\ ?\ \sum_{j?1}^{s} ?_j \log ?_{t?j}^2$.

Once completed the conceptual framework, next section is devoted to the empirical analysis.

III Empirical Study and Results

The series analyzed is the Mexican stock market prices index, known shortly as IPC, the main indicator of the Mexican stock exchange performance. The daily closing values of the index (from April 19, 1990 until February 10, 2003) were obtained from Banco de México website (www.banxico.org.mx). Not accounting for days in which the market exchange was closed, we have 3204 observations. Fig. 1 shows the index time path, which clearly suggests a nonstationary time series.

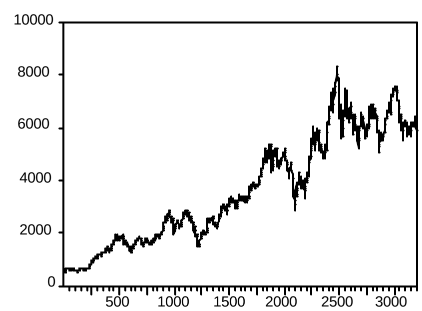

FIGURE 1. IPC TIME PATH

The correlogram for the first 200 lags sugessts a process with long memory effects, because the estimates of the autocorrelation function (acf) and the partial autocorrelation function (pacf) coefficients are 0.999 at the first lag, and at the lag 200 the acf coefficient is 0.782, although the pacf coefficient is only 0.008. The high and significant coefficients at the first lag show a high probability of a unit root process governing the series. So a formal test is at order. The modified Dickey-Fuller test, especified with five lags, an intercept and a deterministic trend, does not allow rejecting the nule hypothesis of a unit root process.

Transforming the series in natural logs first differences, *logIPC (t)-logIPC (t-1),* is a common design to get a stationary series, and, in a very conveniently way, we get an approximation to the rate of return. Fig 2 shows the new series obtained.

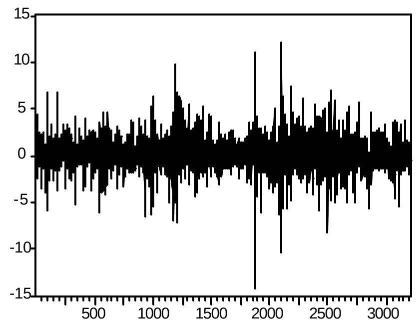

FIGURE 2. *logIPC(t)-logIPC(t-1)*

Now, the Dickey-Fuller test can reject an unit root process on the logs differences, inclusive at less than 1% of marginal level of significance (probability of Type-I error) the existence of a unit root test is rejected. The correlogram of this new series suggests an ARMA process, not being clear the *ad hoc* process to fit the series.

After estimation of several ARMA models with the first 2136 observations (two thirds of the total available sample), a model with significative AR parameters on the first and fourth lags is attained. It is worth to say that the fourth lag estimated coefficient results only significative at a 10%, but its inclusion to continue in our analysis was decided because it produces apparently white noise distributed residuals, as shown by the corresponding correlogram and Ljung-Box test. On the other hand, the correlogram of the squared residuals exhibits some signals of dependence, as shown by the high significant Ljung-Box tests, although acf and pacf with a relatively small absolute value are observed. This dependence is confirmed by a strongly significative Lagrange multiplier test failing to reject the nule of non-existence of ARCH effects, inclusive at a less than 1% marginal significance level (m.l.s.).

The evidence at this point is that ARCH models can be natural prospects to model the volatility of the Mexican stock market returns. An estimation of a GARCH(1,1) model, with Bollerslev-Wooldridge consistent covariance matrix to get homoskedastic errors and right estimated standard errors, shows significative coefficients on the variance equation but an insignificant fourth lag AR parameter in the mean equation, being significative the remainder parameters in the latter. The estimated ARCH and GARCH effects parameters (0.177315 and 0.773657, respectively) are higly significative (less than 1% of m.l.s.), and their sum equals 0.950972, suggesting persistent volatility on the estimation time horizon. Removing the non-significant coefficient the results are essencially the same, suggesting that a robust estimation has been made. Both the inspection of the correlogram and Ljung-Box test shows white noise residuals. The Lagrange multiplier test fails now to reject non ARCH effects.

A joint test, intended to discern if exists dependence of the fitted models squared error on their own past values and if the bias of such errors induced by the sign of past values is significative, was conducted. The evidence drawn from an auxiliar regression points out that it does not matter the sign of the past errors but a higher weight and significance in the case of negative past errors. Thus, two additional models of conditional volatility are specified and fitted: a TARCH (1,1) and an EGARCH (1,1) models, both incluiding an AR(1) specification on the mean equation.

It is worth to note that the main results are the same as in GARCH estimation but the intercept is now weakly significative in TARCH model and it is not in EGARCH model. Both models exhibit evidence in favour of asymmetric effects. Particularly, the EGARCH model coefficient capturing the “leverage effect” is highly significative. Removing the intercept in the EGARCH model mean equation keeps the results unchanged for practical uses. On the other hand, the persistence of volatility in the Mexican stock market returns is shown again. Test of the null $\{?_t\}$?iid(0,1) were conducted (t and z tests for mean; chi-squared test for variance), not being able to reject it for any of the three ARCH models.

The fitted models in-sample forecasting capability was evaluated (see Table 1). Being too similar, is convenient to point out that the EGARCH model shows a better adequacy in terms of the decomposition of the mean squared error, but only in a marginal sense.

TABLE 1. FORECASTING PERFORMANCE MEASURES

	GARCH	*TARCH*	*EGARCH*
ROOT MEAN SQUARED ERROR *	104.7493	104.5301	104.5653
MEAN ABSOLUTE ERROR	78.51273	78.24245	78.2202
MEAN ABSOLUTE PERCENTAGE ERROR	1.3112219	1.307541	1.307102
THEIL INEQUALITY COEFFICIENT	0.0085444	0.008529	0.008535
BIAS PROPORTION	0.004779	0.001103	0.000065
VARIANCE PROPORTION	0.001450	0.001084	0.000768
COVARIANCE PROPORTION	0.993771	0.997814	0.999166
**FORECASTING STANDARD ERROR*			

Then, using the remaining 1068 observations, *ex-post* k-steps forecasts of the level of the Mexican stock exchange index were made. In accordance with the interval forecasts, at 95% of confidence, less than 5% of each model predicted values lies out of the limits stated at two standard deviations, as expected if probability of making Type-I error is fixed equals or less than 5%. Sligthly, asymmetric (TARCH and EGARCH) models are the best performers.

Comparison of some statistiscal measures describing features of the IPC observed values against the predicted level index values by the ARCH models deserves some commentaries. Seemingly, the probability distribution of observed values on the market is reproduced fairly well by forecasts based on ARCH models. Table 2 shows figures of some statistical sample features.

TABLE 2. IPC, AND FORECASTED GARCH, TARCH AND EGARCH SERIES: SOME STATISTICAL MEASURES

	IPC	GARCH	TARCH	EGARCH
Mean	6057.621	6064.862	6061.092	6056.777
Median	6126.235	6135.385	6131.597	6127.595
Maximum	8319.670	8367.842	8363.659	8362.662
Minimum	3300.420	3272.661	3270.085	3265.123
Standard deviation.	912.7699	916.7604	916.2126	915.6699
Skewness	-0.588678	-0.582731	-0.582631	-0.582142
Kurtosis	3.544881	3.529189	3.529168	3.529066
Jarque-Bera normality test	74.89625	72.90613	72.88463	72.77844
(J-B) Probability	< 1%	< 1%	< 1%	< 1%
Observations	1068	1068	1068	1068

As Table 2 shows, at forecast horizon, mean, median and standard deviations of EGARCH forecasted index values are closer to observed values than the other two models. In this sense TARCH outperforms GARCH. Nevertheless, the latter works better in describing skewness and kurtosis of the values observed on the market. The F tests of means do not let us reject equality of the observed and predicted values. Similar conclusions were reached on tests of equality on medians (chi-squared, van der Waerden, and Kruskal-Wallis tests) and variances (Bartlett, Leven, and Brown-Forsythe). In general, the three models behave fairly well in the attempt to reproduce the main statistical features of the observed stock indexvalues sample distribution. Nevertheless, note that, as shown in table 2, all three models overestimate the maximum and minimum values, i.e., they show a trend to forecast more extreme values than observed.

IV. Concluding Remarks

ARCH family models have received a lot of attention by reasearchers and practicioners. Suggested uses go from academic finance research to applications intended to quantify the assets market risk through the measurement of a changing volatility.

Over twelve years of daily closing values of the Mexican stock exchange prices index were studied. It is found that analyzed ARCH models offer a good description of the index series when time-varying volatility estimated with such models is accommodated in the rate of growth (return) according to a theoretical growth equation.

In a very optimistic view ARCH models seem good candidates to study the main stochastic features of the Mexican stock exchange prices index. In short, they could be a good option to represent the unknown data generating process governing the realizations of some financial series. Thus, more reasearch on the ARCH familiy models is warranted, especially since some features of these models are not well known yet.

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The Bargaining Gap: Explaining the Stability of Domestic Foreign Investment Regimes and the Limitations on State-MNE Bargaining in a Globalized Economy

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Abstract

The 1990s have been characterized by a remarkable lack of state-MNE bargaining and overall stability and further liberalization of foreign investment regimes at the national and international level - a state of affairs that is poorly explained by the liberal bargaining model. The paper considers two cases of state-firm bargaining that occurred in Chile and Argentina in the late 1990s in the mining sector in order to assess the limits to the liberal bargaining model, and the explanatory relevance of recent attempts to re-conceptualize it. This paper develops the concept of the "bargaining gap" to represent the shortcomings of the obsolescing bargaining model. It suggests that host countries determine their bargaining preferences with reference to expectations regarding future FDI inflows, not the single investment in question.

Introduction

Over the last thirty years the rules and regulations which govern foreign direct investment in most developing economies (and in the developed world too) have become increasingly liberal and fixed - regardless of the combination of assets (or lack thereof) held, and strategies pursued by the foreign investor. This is a global trend which began with Chile's unilateral adoption of its foreign investment statute in 1974, and subsequently has been promoted on a global level by the United States in bilateral investment treaties (BITs) and international organizations such as the World Bank's Multilateral Investment Guarantee Agency (MIGA), the Organization for Economic Cooperation and Development (OECD), and the General Agreement on Tariffs and Trade (GATT). Such fixed rules have liberalized the investment climate to the extent that there are very few restrictions on foreign direct investors and even less opportunity for host country-multinational enterprise (MNE) bargaining as governments are increasingly tied into a web of international commitments. The global reality is that government policy towards MNEs is now as liberal as it was during the 1950s.[1]

However, these changes have only been reflected in the bargaining literature to a limited extent. This paper examines two case studies of host country-MNE bargaining in the mining sector in Chile and Argentina in the late 1990s. Contrary to the expectations of the obsolescing bargain, attempts to renegotiate the investment bargain were frustrated by the central governments in both countries, which preferred to demonstrate their commitment to the stability of the "rules of the game" than extract more surplus from the foreign firms. Building on the insights gleaned from the case studies, the paper proposes the concept of the "bargaining gap" as a way to understand the limited nature of host country-MNE bargaining in the 1990s.

Wither the Obsolescing Bargain?

The liberal bargaining model pioneered by Raymond Vernon (1971) and Theodore Moran (1974) saw the inevitable conflict between the national interest of the host country and the global interests of the multinational enterprise as resulting in state-firm bargaining over the terms of investment at the entry, operational, and exit stage of the investment (how they would share the expected economic rent).[2]

The bargaining model assumes that there is a potential economic rent (both profits and non-tangible benefits called externalities) from any individual investment by a foreign firm. The TNC and the state determine how they will share the expected rent by bargaining over the terms of the investment. Each determines its bargaining position by assessing what it wants from the other party. Bargaining power is conferred by having some asset that the other party wants, and for which it cannot easily find a substitute. For example the firm may possess capital, technology, managerial expertise, proven access to export markets, while the state may possess human capital, internal market, or unique natural resources. The bargaining outcome that results should be a compromise based on strategy (wants) and structure (power resources and constraints) of the actors.[3] Moran assumed that the original bargain granting the firm access to the country would favour the firm, which received a risk and scarcity premium for its investment. With the passage of time, once the firm had sunk its investment, and the government progressively improved its ability to regulate and even run the industry, the pressures to renegotiate the investment terms in favour of the government increased.[4]

The Resourceful Enterprise

Since this thesis was articulated, however, there has been considerable doubt as to whether the bargaining model accurately described the state-firm relationship. There is little doubt that the original view expressed by Moran and others, that the bargain inevitably obsolesced in favour of the state could not be generalized to any industry beyond the mining sector, or the temporal period of Moran's study which ended in the early 1970s.[5] A series of studies conducted in the 1980s showed that MNEs were particularly innovative in avoiding attempts to renegotiate the original investment bargain.[6] Manufacturing firms, in particular, had a greater range of policy options than extractive industries when faced with government pressure, including manufacturing new products, adding more value, incorporating more technology and even changing the product.[7] Furthermore, firms could avoid an effective loss of control, even if forced to become minority shareholders, through a variety of strategies, including retaining control of strategic functions of the firm.[8] The formation of alliances or links with domestic business groups and government departments or elites could also be an important source of defensive power.[9]

The empirical evidence from the 1990s has further undermined the claims of the liberal bargaining model – the decade was characterized by a remarkable lack of state-MNE bargaining and the further liberalization of foreign investment rules. One the one hand, new research has proven that the period of expropriations was limited both in time and geographically. The "mass" expropriations, which had characterized the 1960s and 1970s, were in fact limited to a small number of regimes (28) and by the 1990s it was possible to claim, without hyperbole, that expropriation was no longer a serious threat to the multinational enterprise.[10] The United Nations *World Development Report* confirmed these observations in its overview of trends in foreign direct investment legislation. Of the 1035 regulatory changes to national legislation governing FDI that occurred between 1991 and 1999 only 5.9% were in the direction of greater restriction on foreign investment.[11] The signing of bilateral investment treaties between countries in the 1990s (96 countries signed BITs in 1999 alone) also extended the legal protection enjoyed by MNEs.[12]

To Bargain or Not to Bargain?

The change in state-firm relations and decline in the relevance of the liberal bargaining model has been addressed in the literature through what may be categorized as three major currents which, in terms of their approach to bargaining in state-firm interactions, may be categorized as asserting the irrelevance of bargaining; the displacement of bargaining; and the maximization of bargaining power.

Many theorists assert that bargaining no longer defines the MNE-host country relationship, and that the (relative) irrelevance of bargaining is reflected in a shift from a conflictive relationship to a more cooperative one.[13] Governments and firms are viewed as increasingly interdependent in realizing wealth and competitiveness in the global marketplace.[14] Recent research has also demonstrated that reducing the restrictions on MNEs can help better integrate them into the global competitive strategy of their parent companies. When this occurs, local subsidiaries are more likely to employ the latest technology and managerial techniques – which have greater spillover effects on the local economy.[15] The central argument is that the strategy of both the the government, has changed since the era of "mass expropriations." Edward Safarian writes, "The key to the new [liberal] approach to TNCs [MNEs] is that policy on FDI and policy on endogenous growth have converged. TNCs are regarded as central to the creation and diffusion of knowledge, within and between firms, and in cooperation with Governments."[16] That is to say that firms have shifted from resource and domestic-market seeking strategies – contentious with nationalists everywhere - to efficiency (or strategic-asset seeking) strategies, at the same time that countries have rejected the import-substitution model in favour of a more liberal and export-oriented approach.[17]

Secondly, the apparent absence of state-firm bargaining in the 1990s may be due to *displacement of bargaining* to other arenas. Ravi Ramamurti argues for a "two-tier" model that takes account of the bargaining which occurs between states in the bilateral and multilateral arena. He suggests that state-state bargaining shapes international investment regimes in such a way that it limits the range of state-firm bargaining options. In this conceptualization, strong states (in the international system) enhance the bargaining power of their firms everywhere.[18] It is true that the aggressive promotion of liberal international rules on foreign direct investment by the United States, and such dominant international agencies as the the IMF, WTO, World Bank's Multilateral Investment Guarantee Agency (MIGA), and the would-be Multilateral Agreement on Investment (MAI), has been accompanied by the adoption of such rules by developing countries.[19]

Furthermore, while national investment rules may be stable, there still exists considerable flexibility in some other areas. Privatization frameworks may be separate from FDI legislation and can demand the fulfilment of specific obligations which vary according to the firm being privatized.[20] In addition, the wave of foreign investment in public services since the mid-1980s has meant the government must play a larger regulatory role than when these industries were state-owned firms. Regulation also offers the possibility of significant discretion (and therefore bargaining) over key issues such as pricing policy.[21] Likewise, other areas of legitimate governmental intervention, such as labour legislation, tariff rates, R&D policy, and subsidies may also be bargaining opportunities.

The third approach explains the failure of bargains to obsolesce through the *dominant bargaining power* of the MNE. In this scenario, either the MNE enjoys greater power resources than the state, or there are constraints which limit the state's ability to act, or both. In mining and other extractive industries, for example, MNEs have reduced the likelihood of obsolescence through project financing their investments and using "prominent victims" such as international banks or multilateral institutions as financial contributors or guarantors. In such cases, expropriation of property, or renegotiation of contracts would be a "crime" not only against the particular firm involved, but also heavy hitting backers such as the World Bank's International Finance Corporation.[22] The use of cross-fault provisions in project financing mean that a host-country default on a IFC loan or guarantee could put other World Bank disbursements at risk, as well as a loss of reputation in other institutions which share directors with the IFC.[23]

Certain structural characteristics of the TNC organization and its particular insertion in the host country economy also strengthen the power of the firm relative to the state. It is a unique source of high technology and knowledge. Global integration of activities may mean that any given investment is an insignificant part of the TNC's overall structure. Production for export may make the firm more "footloose" and willing to close its operations if the terms of its investment are revised. At the same time the host-country is subject to an expanding web of commitments at the international level, which constrain its domestic actions. As a signatory to sovereignty limiting treaties such as the WTO and MIGA it must abide by certain rules regarding foreign investment. If it runs a deficit which requires stand-by loans, or seeks to renegotiate outstanding debts with creditor banks and countries, it must abide by IMF conditionality. Interestingly, much of the anti-globalization movement, arguing that the state is increasingly hostage to international capital in the era of globalization, accords with this position.

A Tale of Two Bargains

The limits on state-firm bargaining in a context of globalization, and the explanatory relevance of the approaches identified above will be examined through a comparative study of the obsolescing bargain in the mining sector in Chile and Argentina in the late 1990s. The mining sector, a long-standing nationalist lightning rod with enormous sunk investments has, since the early work of Theodore Moran, been considered the paradigmatic example of the obsolescing bargain. Mining, and natural resource extraction for export in general, is also likely to be least sensitive to many of the factors identified above as limiting the bargaining power of the state. As the sector in which, according to theory, the obsolescing bargain is most likely to continue to exist, it is an ideal empirical test of its continued relevance.

With the advent of the military governments in 1973 and 1976 in Chile and Argentina, came newly liberalized foreign investment rules. Both Chile's DL600 and Argentina's Law 21, 382 have set the basic rules for foreign direct investment up until the present day. Although the Argentine legislation went through some modifications in the 1980s and 1990s, the stability of Chile's legislation has been unrivalled in the world. It has frozen the rules and regulations regarding foreign investment in Chile for over 26 years. Such fixed rules have liberalized the investment climate to the extent that there are very few restrictions on FDI and fewer opportunities for bargaining. This is even true in mining, which has been the classic example of the obsolescing bargain in state-firm relations.

Nonetheless, there have been occasional attempts to challenge the existing division of economic rent between the state and multinational mining companies. This section discusses two of these attempts: the 1997 tax reform proposal in Chile; and the 1997-2000 royalty dispute between Minera Alumbrera and the provincial government of Catamarca in Argentina. In both cases, renegotiation of the original bargain failed despite an objective increase in the bargaining power of the state since the original contracts were signed. The principal reason in the two countries, was the state's fear of damaging its reputation by changing the "rules of the game."

The Villarzú Tax Reform Proposal

In late 1997, in Chile, there were some indications that the ruling *Concertación* government intended to renegotiate the terms of its investment bargain with foreign firms in the mining sector. The initiative originated with a respected member of the government. In October of 1997, former president of the state-owned copper company, CODELCO, and then Secretary to the President (the second ranked position in the government), Juan Villarzú proposed that a special tax be levied on the "exploitation of non-renewable resources" in Chile.[24] This initiative, known as the Villarzú proposal, was a response to a popularly held view that the foreign mining companies operating in the country were not paying sufficient tax on profits to the government. The government's interest in pursuing this matter was later confirmed by the then-Minister of Mining César Díaz Muñoz. Villarzú broached the subject once again in February of 1998 while attending the World Economic Forum in Davos, Switzerland. Nonetheless, the contours of the legislation remained fairly vague, and the government only committed itself to conduct a study into the implications of a new tax, which included an assessment of some of the means used by mining companies to reduce their tax burden (accelerated depreciation, and use of the mining claim fees – *patente*- as a credit against taxes).[25] The proposed tax was to be applied only to new investments in Chile, not firms which had already established operations.

The debate around the Villarzú proposal was more than a debate about the suitability or legitimacy of certain kinds of taxes on the mining sector. At its core, it was about the nature of the foreign investment strategy. Was it necessary to channel FDI through instruments such as extra taxes, in order to increase the contribution of mining to economic development (as was believed in Chile prior to the dictatorship)? Or was it more important to establish the basic legal conditions to attract foreign investment? Party for Democracy (PPD) Senator, Sergio Bitar underlined this problem in a debate on the subject organized by the local mining magazine, *Minería Chilena*: "It will be difficult to repeat this mining boom, so the question is how do we transform mining into a lever for economic development which goes further."[26] Although some industry leaders recognized the need to increase the contribution of mining to development, mining executives as a whole unambiguously decried the government initiative as uninformed, discriminatory and negative for the industry. Hernán Hochschild, President of the National Mining Society (SONAMI), the association representing privately-owned mining companies, characterized the Villarú proposal as "the most negative fact of the decade for SONAMI."[27]

As previously indicated, the logic behind the Villarzú proposal was the need to compensate for the supposed failure of foreign firms to pay profits taxes to the government. This argument emphasized the contribution of state-owned CODELCO to national development, and simultaneously cast great doubt on the current and future contributions of the private mining industry. In the mid 1990s, CODELCO was contributing more than $US 1000 million per year to the national treasury, while the private sector contributed much less, approximately $US 300-350 million (despite producing almost twice as much mineral).[28]

The mining sector, due to its historical importance in the Chilean economy, and the staggering sums of money invested in the country, had attracted much nationalist attention, and criticism for not meeting the developmental needs of the country. Examples such as Exxon=s Disputada de Las Condes, widely understood in media, government and business circles as not having reported profits in a single year between its initial investment in 1978 and 1998 fuelled this resentment.[29] Suspicion of foreign firms was also enhanced by the failure of most TNCs to publish their annual financial results. Most mining firms in Chile were not publicly listed companies, and consequently were not required to make their finances public. Mining executives tended to view this criticism as the result of misunderstanding the nature of the industry. One mining executive put it this way:

This industry is not as high margin as people think, but it moves massive amounts of money...verything is enormous, contracts, etc, and that mesmerizes people, they forget how much you invest, and that sometimes copper is at $1.20 and sometimes 70¢, which makes a big difference on the return.[30]

The Villarzú proposal faced an immediate reaction the mining sector. Representatives from the largest companies organized a powerful lobby group with the assistance of Senator Ignacio Pérez Walker, a member of the congressional Mining Commission and the right-wing party, Renovación Nacional (RN). A three-pronged strategy was designed in which separate efforts targeted the internal fractures between the parties composing the governing *Concertación* including Ricardo Lagos, leader of the Party for Democracy (PPD); the highest ranking members of the Christian Democrats including the Minister of Economy Eduardo Aninat and then-President Eduardo Frei; and consensus was sought among mining firms and the regional centres of mining activity. Mining firms also agreed among themselves (once checking that the numbers supported their argument) to open their accounts to public scrutiny. This was a key element in making the technical argument that extra taxes were unnecessary and inadvisable. The lobbying effort culminated in a personal meeting between Ignacio Pérez Walker and President Eduardo Frei on December 29, 1998.[31]

The Villarzú proposal was opposed by all the mining executives interviewed for this study on 2 bases: a technical argument, that payment of the profits tax had only been differed until amortization payments were completed; and secondly, a philosophical argument, that the refom "changed the rules of the game" and threatened to undermine Chile's reputation as a good investment climate.

On the first point, the Chilean legislation permitted accelerated depreciation of the amount invested. Only when enough financial profits had been earned to pay down the investment will real (taxable) profits be generated. Such accelerated amortization rules are common to many countries including Canada and Argentina, and are intended to act as an incentive for investors. When combined with taxation rules that specify a higher rate for repatriated profits (in Chile it is 15% on tax base, and an additional 20% on repatriated profits), it is a strong incentive for companies to reinvest in the country (instead of taking profits out). Thus, in Chile, mining companies were simply responding to the investment incentives created by the government - although admittedly, the military one. Since most mining investment in Chile was relatively new (within the last five to ten years), many companies were still amortizing their investments. With huge investments such as Escondida at $US 2050 million, Collahuasi at $US 1860 million, or Los Pelambres at $US 1300 million, it would obviously take some time to pay down the debt and amortize the initial investment.[32]

According to mining executives, comparison with the revenue generated by CODELCO, was also unfair. Taxation on CODELCO is significantly higher than on the rest of the industry in Chile (as it includes both profits tax and the special military tax on sales for a total of 55%) In addition to a higher rate of taxation, the state collects the rest of the surplus due to its ownership of the company. Furthermore, CODELCO had already amortized most of its assets, and was thus unable to use the principal deduction against profits used by other companies.[33] SONAMI commissioned and circulated a paper on taxation in the mining industry. It suggested that there was likely to be a significant increase in profits tax collected by the national treasury between 2000 and 2008.[34]

However, perhaps the most compelling argument from the point of view of the government was the claim that the Villarzú proposal changed the "rules of the game."[35] Opponents of the Villarzú proposal argued that it would seriously damage the reputation of the country, and the foreign investment flows upon which it depended. Over the 1990s, Chile had developed a well-earned reputation as the most stable and professional business climate in Latin America. This reputation had been fundamental in attracting foreign investment in the mining sector, but also in other sectors of the economy. The extent to which Chilean development in the 1990s was based on huge FDI flows made changing the rules of the game a risky proposition.

Furthermore, the international context was not propitious for following up the proposal. The Asian crisis and its effects on the price of metals, especially copper which fell below US 70¢ a pound in 1998, threw the entire mining sector into crisis, and the country into recession. Many firms, including foreign MNEs had to close unprofitable mines (such as Barrick Gold's El Indio, and Phelps-Dodge's Ojos del Salar). In this context, Chile's bargaining strength was low, and government efforts were focussed on maintaining existing employment levels in the industry.

The government abandoned the project due to a number of reasons: political opposition (within and outside the PDC); the lobbying efforts of the mining firms and Ignacio Pérez Walker in the Chamber of Deputies, Senate, and Congressional Mining Commission; and the low price of copper in 1998.[36] On February 18, 1998, President Eduardo Frei publicly reprimanded Juan Villarzú for his proposal, and stated that the government had no plans to increase the taxation rate on the private sector and was committed to stable rules of the game.[37]

Minera Alumbrera Royalty Dispute

At $US 1.2 billion, the Minera Alumbrera mining project was the largest single mining investment in Argentine history. Many considered it to be the test case for mining in Argentina. It was a test, above all, of whether the revision of Argentina's mining legislation in 1993 had really changed the investment conditions and attitudes of provincial governments in such a way as to make the country an attractive destination for foreign investors. Enrique Loncan, President of Barrick Explorations expressed it as follows,

Bajo la Alumbrera is the first megaproject established under the new mining legislation, and as a result puts to the test the consistency of the legal and fiscal framework that will determine its feasibility. As a consequence, the international community considers this investment to be a reference point.[38]

However, the Bajo de la Alumbrera project became a "reference point" for the first major round of state-firm bargaining in Argentine mining. In this case, the Radical government of the province of Catamarca under Governor Arnoldo Castillo, where the mine was located, sought to increase the value of royalties paid by the foreign company. Unlike the Villarzú proposal, which never really got off the ground, the royalty dispute pitted both the federal government and Minera Alumbrera against the province of Catamarca. However, the principal argument against the changes was the same as that used in Chile - changing the rules of the game undermined the country's reputation as a good business climate.

Shortly after Minera Alumbrera had sunk half of its $1.2 billion dollar investment, the government of Catamarca announced that it would be charging the company a royalty of 3% on the mine-head value of its production. However, unlike the firm's definition of "mine-head value" which included a deduction of all costs incurred between the extraction of the mineral and the first stage at which it was priced, Catamarca would not allow any deductions. This added significantly to the value of the royalty. Firm executives calculated that it effectively doubled the royalty to 6%, or an extra $US 8-9 million per year.[39]

However, the government of Catamarca found itself opposed by both Minera Alumbrera and the national executive.[40] From the viewpoint of the Nation, Catamarca's royalty stance undermined the rule of law, and put in jeopardy the entire structure of stable rules which was to make possible the development of Argentina's mining potential. It was an attitude emphasized by the President of Minera Alumbrera,

The uncertainty that exists as a result of the current situation, presents other entry barriers to those who wish to invest, not only in Catamarca, but also in Argentina... If the consensus falls apart at the first opportunity, independent of who is correct and who is mistaken, the victim is the confidence of those who contribute the capital and financing.[41]

The royalty issue was thus part of a larger problem faced by Argentina, the problem of the "rule of law" – and the fact that foreign investors (and local investors for that matter) perceived that they could not count on the impartial, effective rule of law.[42]

The dispute had emerged out of the federal division of powers, which allowed the federal government to define national mining policy and legislation, but which gave the provinces the right to apply and enforce it. In May 1993, as part of its renovation of the national mining legislation, the federal govemment passed the Mining Investment Law 24,196, which limited the royalties that could be charged by the provinces to 3% of the mine-head value (*valor boca mina*). The Federal Mining Accord Law 24,228 then secured provincial agreement for these changes. Since Argentine legislation is made effective through its later regulation, it was assumed that "mine-head" value would be defined in more detail when the law was regulated. Mining executives claimed that the term was widely recognized in international mining circles, as meaning the value of the mineral at its first stage of commercialization (first stage at which a price can be attributed to it) minus the costs incurred between its extraction and that stage, including amortization.

However, Catamarca adhered to the federal legislation regarding royalties, on 17 November 1993, but not before passing its own law on royalties in October. The Catamarcan law accepted the 3% royalty, but failed to define the calculation of mine-head value - thus leaving space for its own interpretation of the formula. On December 28, 1993, the federal government issued Decree 2686 which regulated the Mining Investment Law, and defined *valor boca mina* as the price of the mineral at the first stage of commercialization with the deduction of costs incurred between extraction and sale. However, Catamarca's regulation of its own royalty law did not accord with the federal definition, and neglected to add the deductions to the calculation of mine-head value.[43] According to the Catamarcan authorities, the fact that its royalty law predated its adherence to the federal law, and that it had the constitutional right to regulate its own laws, meant that its own interpretation of the *valor boca-mina* took precedence.[44] Since Catamarca had previously accepted the federal definition of "mine-head value" in its 1994 contract with another foreign company operating in the province (FMC Lithium), its stance seemed particularly opportunistic.

Catamarca was following a traditional bargaining strategy. Once the investment was sunk, it changed the rules of the game to extract more rent from the firm. From the province's point of view, the firm would have little choice but to pay the relatively paltry surcharge demanded by the province. Interviews revealed that the government of Catamarca made the move because it thought its bargaining power was strong, and it could get away with it. Catamarca was the province with the hottest prospects for new mining development, with dozens of foreign exploration companies (juniors) operating in the region, and many deposits already identified and owned by the province. The province viewed the payment of royalties as legitimate compensation for the extraction of a non-renewable resource. In addition, it believed there was extra surplus to be gained at the Bajo de la Alumbrera site, which unlike many other sites, had a high mineral grade and relatively easy conditions of access (low altitude), and was therefore assumed to be highly profitable. At the core of the argument was the assumption that there were profitable opportunities in the province, and a little extra bargaining by the province would not change those fundamentals.[45]

There were also political calculations behind the conflict. Catamarca had one of the highest unemployment rates among all the Argentine provinces, and by the start of operations in mid-1997 the development at the Alumbrera site had already frustrated high local expectations regarding its economic impact on the surrounding regions. Facing gubernatorial elections in March 1999 the governing party (a provincial variant of the Radical party, the Unión Frente Cívico) found it useful to portray Minera Alumbrera, the federal government, and the Peronist party governing at the federal level, as deliberately preventing Catamarcans from cashing-in on their birthright.

The national executive, Minera Alumbrera, and the government of Catamarca entered into negotiations to resolve the issue. All parties rejected taking the issue to the Supreme Court, although it clearly fell within the Court's competence. The firm thought a political solution would offer more enduring stability, while the province recognized that a lengthy court battle would delay its ability to collect its royalty payments - if it could win in a court dominated by the appointees loyal to the President. The national executive on the other hand feared the damage to Argentina's reputation that the publicity surrounding a court case might cause.[46]

Negotiations took place through the Federal Mining Council at which all the provinces were represented, and the Bicameral Commission on Mining (of the Argentine Congress). The Commission consulted with the private sector, the Council, and the province of Catamarca. As a result of these consultations, it proposed a definition of *mine-head value* which was to allow all deductions except amortization.[47] The new deal was to cost Minera Alumbrera 25-30% more than the original royalty law.[48]

In addition, a Compensation Fund For Development was to be established. Paid for by federal monies, the fund was intended to compensate the province for the income lost from adopting the new definition of mine head value. The changes required modifications to the original Mining Investment Law, which had to be passed by both houses of Congress, and the provincial governments. The project law was passed by the Senate in June 1998, but without the support of the Catamarcan representative.[49] The final version of this law, sanctioned in November 1999 also failed to get the necessary provincial approval. By mid-2000 the conflict remained unsolved.[50]

Interestingly, the solution to the royalty issue was not pursued through state-firm bargaining, but rather inter-governmental bargaining, in which the federal government of Argentina took the side of a *foreign* firm against a recalcitrant provincial government. The fundamental argument which motivated the federal government to move decisively against the actions taken by the province of Catamarca, was the fear that changing the rules of the game would negatively impact foreign investment flows if investors thought that their investments were vulnerable due to political and judicial insecurity. This was confirmed by the efforts made by the political authorities (both federal and provincial – other than Catamarca) to underline their commitment to the rules of the game, and condemn Catamarca for breaking them.

Is There A "Bargaining Gap?"

The "bargaining" experiences of both the Bajo de la Alumbrera royalty dispute, and the Villarzú proposal reveal the extremely limited nature of bargaining in the epoch of neoliberalism. Not only was the bargaining in those cases limited to relatively insignificant issues, but in both cases the attempt to extract more surplus out of the foreign firms failed (in significant part) because the central government realized that the country's reputation as a good investment climate was worth more than what it would gain from the bargaining.

Curiously, the explanations for the apparent lack of bargaining in the 1990s summarized in the literature review do not seem to explain well the outcome in Chile and Argentina. On the one hand it is clear, that the liberal bargaining model does not adequately explain these truncated bargaining experiences. The Chilean case is perhaps more striking. In 1974, the military government in Chile promulgated a new statute on foreign direct investment, Decree Law 600. At the time, DL 600 was almost unique in the developing world for its liberal and permissive approach to foreign investment. It also marked a radical shift in Chilean policy. Under democratic governments since the mid 1960s, investment policies had become increasingly restrictive towards MNEs, culminating in Chile's adherence to the Andean Pact's FDI regime (Decision 24) and nationalization of the foreign copper companies under Salvador Allende.

What is particularly interesting about DL 600, however, is that (apart from some very minor adjustments) it froze the rules and regulations regarding foreign investment in Chile for 26 years. That is to say that changes in the relative bargaining power of the state and MNEs (which must have fluctuated over the last quarter century) have apparently not been reflected in the legal norms that govern foreign investment (which have remained constant). This defies all expectations of the liberal bargaining model. When Chile promulgated DL 600 in 1974 the country was in a deep recession, the government was running a large deficit and desperately needed foreign exchange, and foreign direct investment had all but dried up following the nationalization policy pursued by the Allende government between 1970 and 1973. In this context, it was reasonable to expect that Chile's bargaining power was at an all-time low, and that the massive liberalization envisioned by DL 600 reflected these circumstances. By 2000 however, Chile had experienced fifteen years of solid growth, persistent balance of payments surpluses, and huge inflows of foreign direct investment. It would be pure nonsense to suggest that Chile in 2000 had the same or less bargaining power than Chile in 1974 - and yet DL 600 remained basically unaltered. Contracts signed in the 1970s did not obsolesce – even in the mining sector, the classic example of the obsolescing bargaining literature.

But it is not clear that the three alternative views, the irrelevance of bargaining, the displacement of bargaining, and the maximization of bargaining power offer much more compelling explanations for the stories of the Villarzú proposal and the Minera Alumbrera dispute. In terms of the irrelevance of bargaining – the strategy of host country may be more in tune with that of the firm (at least in terms of encouraging larger FDI flows) but in the natural resource sector where mines often operate as enclaves, we should not exaggerate the spillover effects (beyond employment multipliers). The host will never have the kind of strategic symbiosis in this sector than it would in high-technology manufacturing for export. Therefore we cannot explain the failure of bargaining in terms of such a synergy. While it is true that the general relationship between host country and MNE is vastly improved over the 1970s, we also see that conflict and the desire to extract a greater share of the rent from the investment persists.

In this case, we cannot say that bargaining had been displaced to the international level. Taking Ramamurti's hypothesis as an example, that weak firms with the backing of strong states will triumph over host governments (and strong firms backed by weak governments will fail) – because of the influence of these home countries at the international level – we find it is falsified. Minera Alumbrera is an example of a weak firm (because of its sectoral location) backed by relatively weak governments – at that time it was owned by Australian and Canadian companies. Minera Alumbrera should have been the paradigmatic example of a bargaining player that would lose, instead, it lost very little. Nonetheless, a curious and unexpected displacement of bargaining did occur when the government of Argentina took the side of the firm against its own provincial government. This is probably explained by the executive's concern that the Catamarca-Minera Alumbrera conflict had implications far beyond the single firm itself. It was this concern that caused the displacement of bargaining and ultimately the relatively favourable outcome for the firm, not the displacement itself that was causal – as in Ramamurti's thesis.

Nor does it appear that the mining firms in both stories triumphed because their bargaining power was maximized. With the low price of copper in 1998, and the overall dependence of the Chilean economy on mining, there is little doubt that the bargaining power of the government was not at its highest point. Nonetheless, as the history of the foreign investment statute indicates, it was much improved over the time when DL 600 was promulgated. Perhaps most importantly however, the ability to tax (the issue of the Villarzú proposal) is not usually restricted by foreign investment regimes at the international or bilateral level. In Chile's case, the Foreign Investment Committee signs contracts with foreign firms committing the government to a certain tax rate for a certain period of time. But even this was not violated by the Villarzú proposal, which envisaged a tax on future investments. In this respect, neither the maximization of firm bargaining power, nor the web of international investment treaties, which may have constrained Chile's actions, can be viewed as explanatory.

Learning from the Case Studies

The two case studies of host country – MNE bargaining discussed in this article shed some light on the reasons behind the limitations on state-firm bargaining in the 1990s. In terms of the examples often provided in the literature, they are unique for three principal reasons:

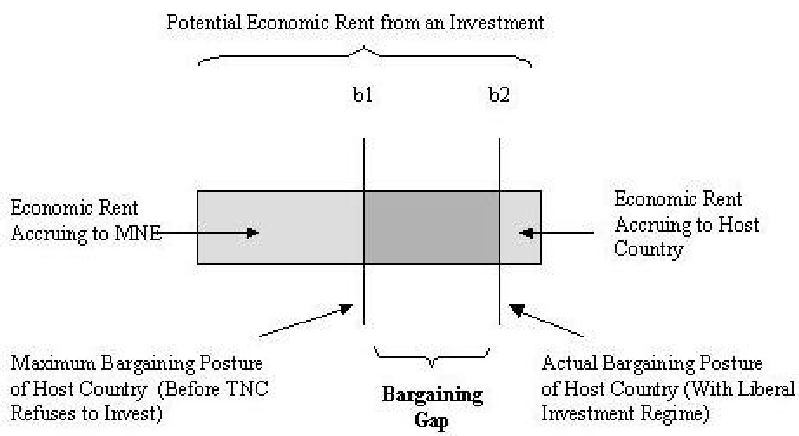
1) They demonstrate both bargaining attempts and the failure of those attempts in liberal economies with a history of openness towards foreign investors.
2) They show the importance of political factors in bargaining attempts and outcomes – particularly that firm-specific advantages (such as technology, changing product mix, etc.) usually considered to be determining in bargaining outcomes due to their effect on firm bargaining power were less important than political factors ostensibly unrelated to the firm. In Chile, the political strength of the right and its determination to resist regulatory encroachment was fundamental to the outcome. In Argentina, the federal-provincial division of powers and responsibilities played an important role.
3) The importance of the national strategy for economic development to bargaining. In particular, the dependence of both the Chilean and Argentine economy on large FDI inflows made both governments wary of doing anything to prejudice those flows.

Modeling the Limits to Host Country-MNE Bargaining

This section represents the limits on bargaining graphically in Fig.1 and uses the observations above to seek a theoretical explanation – that may be used to supplement the liberal bargaining model. The core of the problem is viewed as the state's unwillingness to push its bargaining advantage in any one particular investment. When investment terms for a particular foreign investment are agreed upon, most bargaining theory assumes that both the state and the firm make an assessment of the advantages it wants from the other. Based on this assessment, the two parties bargain over the division of economic surplus, or rent, the parties expect will be generated by the investment. The entire theory is contradicted by the existence of fixed investment rules in countries like Chile and Argentina. This stability means that the host country does not make any assessment of the advantages brought by a single MNE or change its bargaining posture from one MNE to another.

If the host country makes no attempt to extract the maximum benefits from a foreign investment, then the its actual bargaining posture (none) falls significantly short of the maximum position it could hold before the MNE decides it is no longer profitable to invest. The difference between the potential bargaining position of the state (b1) - up to the maximum point where the MNE determines the investment is no longer profitable - and the actual posture (b2), I call the "bargaining gap." It is illustrated by Fig. 1.

Fig. 1: The Bargaining Gap - the Potential and Actual Division of Economic Rent between MNE and Host Country



Proposition 1: thus we can conceptualize the absence of (or limits on) host-MNE bargaining, as the difference between the maximum and actual bargain, or the value of b1-b2.

The two case studies also revealed the importance of political factors. This is not a new observation, for example, Moran's 1974 classic suggested that the 1954 *Nuevo Trato* in Chile (the first major liberalization of mining legislation) was part of a broader political deal to strengthen the political right. At this time the government traded lost economic rent (extra taxation on the foreign mining firms) for other political objectives. Other theorists have noted the general failure to consider political factors in bargaining models, Rhys Jenkins observed, "What is common to these [both liberal and dependency] approaches is an inadequate theorization of the state, and a tendency to view the state as unproblematic."[51] In contrast, we assert that the state has both political and economic interests (it is never wholly autonomous from domestic social forces).

Proposition 2: economic rent may be traded for political goals.

The case studies also identified the principal motivation behind the host county's decision to fight against the bargaining efforts of its subnational jurisdiction in Argentina, and to abandon a controversial tax proposal in Chile, as fear of changing the "rules of game" and the impact that would have on future foreign investment inflows. It seems clear then, that a host-country does not define its bargaining posture towards a particular foreign firm, without considering the effect of that posture on other (yet imaginary) foreign investors. When the development strategy of the country is dependent on FDI inflows and when there are few alternatives, it is hypothesized that the host country will give even greater consideration to its present decisions on imaginary future investors.

Proposition 3: host country bargaining posture is not only determined by reference to a particular state-firm relationship but also to the value (both economic and political) of a hypothetical future-projected series of bargains (fut-b).

Proposition 4: the host country also considers the value of a hypothetical future-projected series of second-best alternatives (fut-alt).

Based on these propositions, we can come to some conclusions regarding what conditions increase or decrease the limits on host country –MNE bargaining. As the value of the future-projected series of second-best alternatives (fut-alt) approaches the value of the future projected series of bargains (fut-b) the host country will strike a harder bargain and its actual bargaining posture (b2) will approach its maximum bargaining posture (b1). When the value of alternatives is equal or more than the value of future bargains, the bargaining gap will be zero, and the host country will maximize its bargaining power. When the the bargaining gap equals zero, the calculation of the host country's bargaining posture will follow the normal logic of the liberal model. In contrast, the bargaining gap will approach its maximum size when there are almost no second-best alternatives (fut-alt=0).

It must be remembered that political factors are integrated into the determination of the state's bargaining posture. Political factors are therefore included in the calculation of value that can be attributed to a series of investments. Some vested economic interests with influence over the government may be willing to trade a lot of the potential economic rent from future foreign investment flows if more liberalized flows will damage their opponents politically and economically. Political factors may be more or less important depending on the context and perceptions of value associated with the hypothetical investment flows and hypothetical second-best alternatives. A neoliberal government supported by the country's largest conglomerates – as was the case in Argentina, and to a lesser extent Chile in 1998, would find the second-best alternative of increased state involvement in the economy as having very little value – thus tending to increase the size of the bargaining gap.

This means that the objective assessment of whether certain MNE or host country characteristics increase or decrease bargaining power or likelihood of regulation of a particular investment - indeed a table of such assets and powers is *de rigeur* in most books on bargaining - is influenced by other concerns: namely the calculations made by the government regarding the hypothetical future value of all FDI flows, and the alternatives which exist to those flows.

Conclusion

As economic crisis and declining FDI inflows have gripped Latin America over the last two-three years, and new left-leaning governments such as Argentina's Néstor Kirchner, Brazil's Luiz Inacio "Lula" da Silva. Ecuador's Lucio Gutiérrez, and Venezuela's Hugo Chávez seem to herald a new era in state-firm confrontation, it may be asked what the implications of the "bargaining gap" model are for predicting how the pendulum of host country-MNE bargaining will swing – towards more liberalization of foreign investment rules, or towards less?

One the one hand, declining FDI flows to the region, and the new-left ideology of many of Latin America's new leaders have undoubtedly reduced the hypothetical future value that governments attribute to these inflows. However, as a result of the crisis, the alternatives are also greatly reduced. It is unlikely that inflows of portfolio capital will reach 1998 levels for many years, and the ongoing fiscal crisis of the state, and completed privatization of many state-owned enterprises has not left governments in any position to re-start a nationalization process. As a result, the balance continues to weigh in the favour of less regulation, not more.

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Cost of Capital: The Factor Influencing Economic Value Added

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Abstract

Economic Value Added (EVA), an indicator of newly created value for the owners of a company, is an important tools for measuring companies' performance. Costs of capital play a very crucial role among the major factors that influence EVA. This paper attempts to:

- **Explain the nature of influence of costs of capital in creating economic value added,**
- **Introduce different methods for the calculation of cost of capital and difficulties involve in each method,**
- **Explain the importance of selecting suitable sources for companies' financial stability.**

1. Economic Value Added

Efficient capital management is one of the important areas of a competitive market. The basic aim of companies' activities in countries with advanced market economy is to use their equity as well as debt in a productive way that maximizes the market value of the company in a sustained way. Thus the general aim of a company is to maximize the market value for its owners [1], [2], [4], [5], [8], etc. To measure the creation of economic value for different companies and to compare their performance we need a common tool. Economic Value Added (EVA) checks the companies' value creation and evaluates companies' effectiveness and managerial performance.

Economic Value Added (EVA), the registered trade mark of Stern Stewart & Co., is one of the highly discussed topics in today's financial world. It is because EVA can define the amount a business generates through the measurement of rate of return over cost of invested capital. Economic value added is a financial performance measure that helps to reduce capital costs and improve profits, which in turn increase shareholder's value.

According to Tully, 1998 [7], EVA is a simple measure that provides information about shareholder's real wealth creation. As maximizing shareholder's wealth is the main motive of most privately held for-profit companies, application of EVA is becoming increasingly popular in today's business world.

Calculating EVA involves a few pre-requisites steps like i) Calculation of Net Operating Profit After Tax (NOPAT), ii) Identification of Company's Capital, and iii) Determination of Cost of Capital. All the above steps are important and involve certain crucial calculation. Creation of economic value can be calculated as follows:

$$\boldsymbol{EVA} \ ? \ \boldsymbol{NOPAT} \ ? \ \boldsymbol{Capital} \ ? \ \boldsymbol{WACC} \tag{1}$$

Where, NOPAT = Net Operating Profit After Tax
WACC = Weighed Average Cost of Capital

Thus economic value added is influenced by profit, amount of capital (bearing the cost) necessary to finance the assets, and amount of cost of capital (Figure 1).

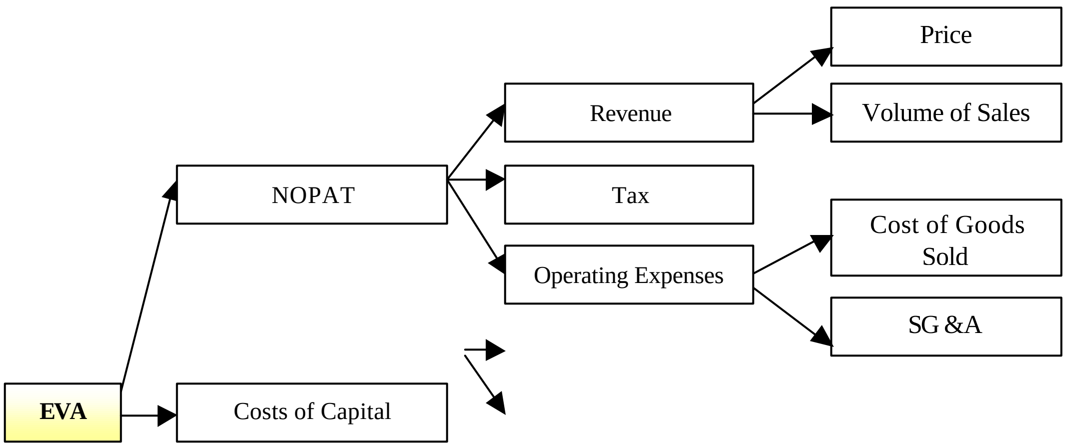
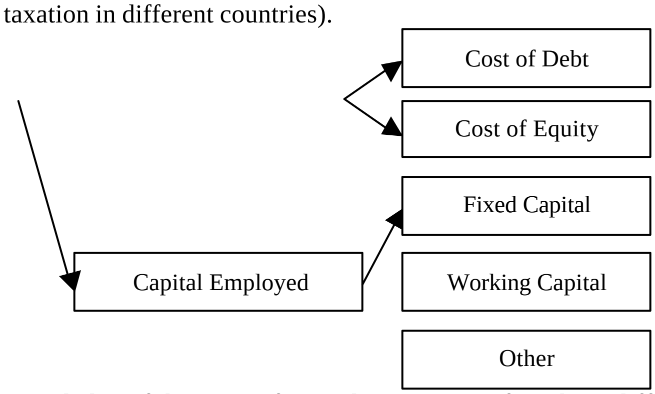


FIGURE 1: USING VALUE TREE ANALYSIS TO ASSESS SENSITIVITY OF EVA TO VALUE DRIVERS [13]

The required profit can be realized by good structure and adequate value of assets. However this should be connected with effective investment in projects with a required rate of retum. These projects should be financed in such a way that the price of these sources does not exceed the investment effects.

The amount of capital expenses available to a company depends on the structure of this capital i.e. on the ratio of the equity and debt. The amount of capital expenses depends on the effectiveness and the risk of business activities of individual companies. Companies with high rating usually obtain capital at lower costs or can obtain it easily and at lower cost at international financial markets (it is even possible to take advantage of different interest rates and taxation in different countries).



Knowledge of the costs of capital is important for taking different financial decisions, especially those with strategic character (e.g. investment plans realization, selection of the source of finance, company evaluation etc.). In addition, all these spheres of financial management are closely interconnected. Therefore, it is always important to study the problems of calculating the costs of capital.

2. Costs of Capital

Calculation of costs of capital is one of the difficult tasks in companies' financial management**.** Cost of individual capital is the cost borne by a company in connection with obtaining and utilization of a particular types of capital (e.g. share capital, credits, bonds etc.). The average cost of capital of a company is a weighed average of cost of individual types of capital.

2.1 Cost of Debt

Cost of debt can be expressed, as the income required by the creditors (investors). The real cost of debt is the cost that takes into account taxes, and cost connected with possible issue of securities (2). If the interest is variable i.e., tied to one of declared bank rates with a fixed percentage surcharge then it is important to know the rating of the company and prognosis of basic macroeconomic values. Cost of debt can be calculated as:

$$r_d \ ? \ i ? 1 ? T ? \qquad (2)$$

Where, r_d ? cost of debt in percentage

i ? interest rate (bonds) in percentage

T = company´s tax rate (tax on profit in percentage / 100)

2.2 Cost of Equity

For the calculation of cost of equity the Anglo-Saxon countries have adopted a concept based on the theories of capital market. It is because, in Anglo-Saxon countries the capital is obtained mostly from capital markets. These theories are quite simple. The cost of equity can be determined with the help of the share prices that reflect the condition and prospects of the company on liquid (flexible) markets. Because of well-operated financial markets in the USA and in the Great Britain, the banks have remained weak. On the other hand, in most of the European countries, the financial institutions, especially universal banks and insurance companies showed higher growth than financial markets. Formation of liquid and stable market is a long journey in a small country. For this reason, historically, the task of capital allocation has been taken over by banks in most of the European countries. This is also a reason why sometimes the relatively simple Anglo-Saxon models cannot be applied fully in today's European practice. For this reason new models have emerged in Europe.

2.2.1 Models Used for Determination of Cost of Equity

There is lot of approaches to determination of cost of equity. The basic approaches are referred in Figure 2.

Capital Asset Pricing Model (CAPM)

The model that determines the cost of equity makes use of the data from the capital market. Efficiency of market is important here. For this reason it is used in Anglo-Saxon countries in particular. In Germany and other West-European countries this model wins recognition in theory rather than in the corporate practice.

The aim of CAPM is to explain the relation between the level of exchange rate and the security risk. The cost of equity capital can be calculated by adding the rate of return of risk-free investment and the risk premium set with the help of information obtained from the capital market. Cost of equity capital can be calculated by the following formula.

$$r_e \ ? \ r_f \ ? \ ß_i \ ? (r_m \ ? \ r_f) \qquad (3)$$

Where, r_f = risk-free rate

$r_m - r_f$ = risk premium of the capital market (equity risk premium)

$ß_i$ = change in rate of return of shares of a certain company in dependence on the change in rate of return of the capital market (stock beta)

If we want to use this model, we must be able to determine the risk-free interest rate, risk premium and the level of ?.

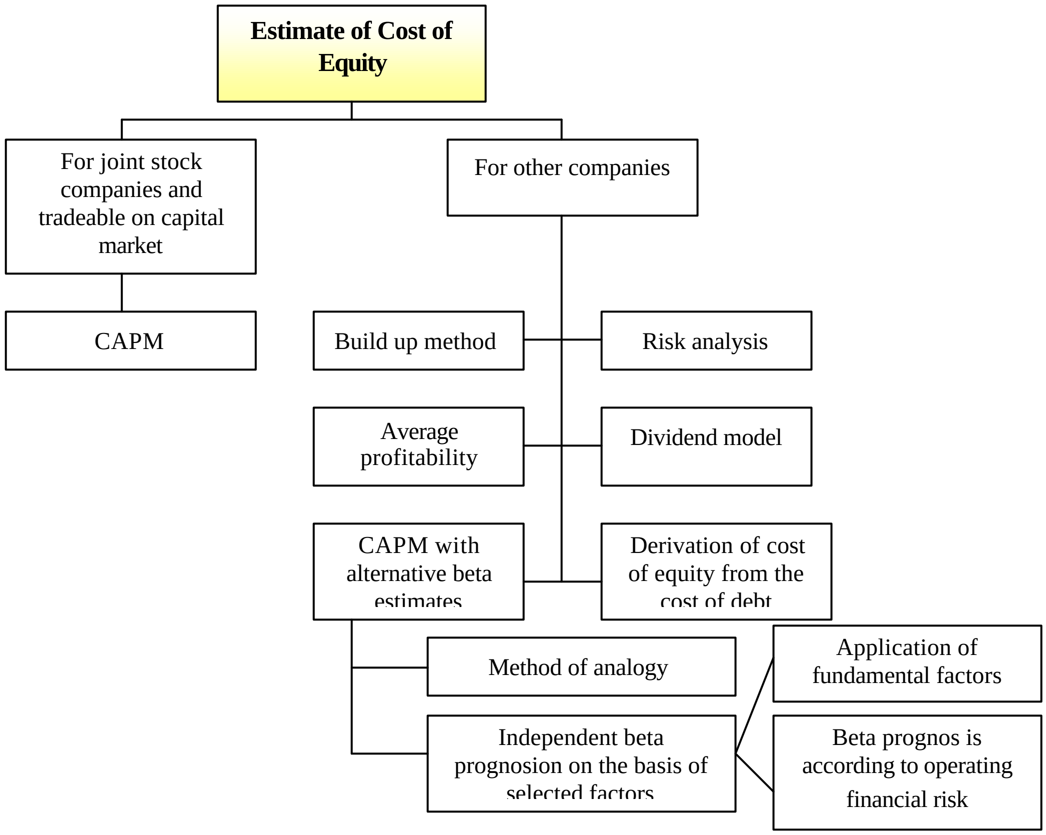


FIGURE 2: BASIC APPROACHES TO ESTIMATE THE COST OF EQUITY [3]

Although there are no risk-free assets in general, state treasury notes or state bonds are considered as very little risky (interest rate of ten-year state bonds is usually recommended to consider as a risk-free interest rate). Risk-free rate reflects development of the macroeconomic environment. Even this rate, although considered risk-free, includes inflation and a surcharge for the decreased liquidity in it.

Risk premium can be determined by the rate of return of assets on the local capital market, and on the basis of calculation of the average rate of return of state bonds. The risk premium is then derived as a difference of the two values. Market yield is set mostly by means of exchange indices. But this does not correspond to the theoretical prerequisite of this model, where all tradable assets should be considered.

The basic procedure to estimate the coefficient ? is to find out regression dependence between the stock yields and market yield. The slope of the straight line is the value of the parameter ?. Source of data in the time series data of share prices and value of global indices. Consideration of a long period enables to use more data, but older data lose their sense. In the USA a period of 2-5 years is generally used.

Companies that are not tradable in public markets, the cost of equity capital can be estimated using the CAPM model with alternative estimates of ?. This maybe by using analogy or independent prognosis of ? on the basis of selected factors.

The CAPM model is blamed for variability of beta coefficients and thus for big differences in the calculated cost of equity. Since the model has several prerequisites on risk-free borrowing and lending rates, possibilities of trading all assets, etc., practical application of the model is complicated. Many of these prerequisites are not met even in the most developed countries, not to say in transitive economies like the Czech Republic with little developed capital market.

The latest empirical researches refer that other risks are decisive for the determination of capital cost on the capital market than the fluctuation of yields (i.e. identification of the risk and ? coefficient). For companies whose market value does not exceed the book value, higher risk is usually considered.

Build up Model

The basic principle of build up models is to add a certain surcharge on risk to the risk-free interest rate. An example of the build up model used for calculation of the cost of capital in the Czech Republic is the INFA model [4]. The model uses the following procedure for the calculation of the cost of equity capital (altemative cost).

$$r_e = r_f + r_{size} + r_{entrepreneurial} + r_{FinStab} + r_{FinStr} \tag{4}$$

Where, r_f = risk-free rate
r_{size} = function characterizing size of the company
$r_{entrepreneurial}$ = function characterizing earning power
$r_{FinStab}$ = function characterizing the relation between assets and liabilities
r_{FinStr} = function characterizing capital structure

Dividend Model

The main idea of this model is that the value of the share is given by the present value of revenues, which can be expected from this share (dividend, selling price).

For the assumption of an infinite share holding, it can be expressed as:

$$r_e = \frac{D}{P} + g \tag{5}$$

Where, D = dividend paid,
P = market value of share,
g = annual growth of dividend

Dividend model is very simple and easy to calculate for the companies those pay dividends and have adopted stable dividend policy.

Average Profitability in the Sector

Another possibility to determine the cost of equity capital is using the data of average profitability of the equity capital in the sector. The main advantage here is that the data on profitability are better accessible than the other data. Problem arises when the sector is in critical situation, and when too low or even negative profitability is reached. This model is not advisable in a situation of higher profitability in the sector.

Derivation of the Cost of Equity Capital from the Cost of Debt

This procedure presupposes that the cost of equity capital is higher than the cost of debt. Since the owner bears higher risk than the creditor, owners usually call for higher yield. This can be estimate by the following procedure:

- Find out a real level of cost of debt
- Add some percentage to the cost of debt, which give a certain estimate of cost of equity capital.

2.3 Weighted Average Cost of Capital (WACC)

The weights at WACC calculation are the share of debt and the share of equity capital on whole capital (in market values) (6).

$$WACC = \frac{Debt}{Capital} \times (Cost\ of\ debt) \times (1 - T) + \frac{Equity}{Capital} \times (Cost\ of\ equity) \tag{6}$$

Where: Capital = sum of the market value of debt and equity finance
T = company´s tax rate

When determining the structure of capital in market values, either the present structure of capital or the target structure of capital or structure of capital common at comparable companies can be used. If change in structure of capital is a part of strategic decisions, then it is necessary to start with the target structure of capital [2]. But in many cases, it is very problematic to determine the market value of capital particularly for companies non-tradable in capital markets. To calculate the value of capital through yield-making methods, it is again necessary to know the cost of capital. Thus we can see ourselves in a vicious circle.

Economists such as Sweeneye *et al*. 1997 [6] refers to the fact that empirical studies that deal with the average cost of capital or use it often, rely on book value of the debt, even if the theory promotes market value application. This procedure can have a negative influence upon the calculation of indebtedness rates and the cost of capital. Differences in book and market capital structure are determined by changes in the level of interest rate. (Market value can be influenced by the fact that indebtedness can influence the value of the previous debt. This applies in the case when further indebtedness is motivated by unexpected fallout of the cash flow). Especially bonds show different book and market values.

2.4 Case of Granitol, a.s. Company

Each model (especially models for calculation of cost of equity capital) has its own problems in obtaining the required input data or in accuracy starting from subjective approach to their estimation. The example of Granitol is demonstrated here to show the individual procedures used for calculation of the cost of capital. The company is a joint stock company employing 420 people and at present the biggest manufacturer of polyethylene foils in the Czech Republic. The basic data used in this example have been taken from the annual reports of Granitol, a.s. company [12].

Determination of Cost of Debt

The cost of capital that the company obtains as debt is expressed as an interest that the company has to pay. Granitol, a.s. uses only one outside source for its long-term financing i.e., bank credit. If we consider the income tax as 35 per cent in 1999 and 31 per cent in 2000 and 2001, the cost of debt will be as follows [1].

$\mathbf{r_{d1999} = 8.85\% \times (1-0{,}35) = 5.75\%}$

$\mathbf{r_{d2000} = 12.11\% \times (1-0{,}31) = 8.36\%}$

$\mathbf{r_{d2001} = 10.81\% \times (1-0{,}31) = 7.46\%}$

Determination of Cost of Equity

Capital Assets Pricing Model (CAPM)

As Czech capital market is not developed sufficiently, the CAPM model cannot be used for determination of the cost of equity capital. However, there is a possibility to use the CAPM model with alternative estimates of ß. Another way to determine the coefficient ß is by using the method of analogy. The idea of this method is very simple. Here average ß of similar companies is used. This method also considers the influence of capital structure and ß is adapted according to the relation:

$$ß_D = ß_E \times \left[1 + (1 - T) \times \frac{D}{E}\right] \qquad (7)$$

$ß_D$ = ß of equity capital with the company in debt

$ß_E$ = ß of equity capital at zero indebtedness

T = income tax rate

$$\mathbf{ß_{1999} = 0.81 \times \left[1 + (1 - 0.35) \times \frac{154770}{316044}\right] = 1.07}$$

$$\mathbf{ß_{2000} = 0.55 \times \left[1 + (1 - 0.31) \times \frac{134105}{333952}\right] = 0.70}$$

$$\mathbf{ß_{2001} = 0.59 \times \left[1 + (1 - 0.31) \times \frac{112605}{339270}\right] = 0.73}$$

The risk premium of 5.5 per cent that is valid in the USA was used for the calculation in the analyzed years. A surcharge of 1.5 per cent was added to it, allocated for the Czech Republic on the basis of a rating (for detail see http://pages.stern.nyu.edu/~adamodar/). The "risk-free" premium is considered as 7.6 per cent, 6.5 per cent and 6.3 per cent in the Czech Republic for the individual years (for detail see http://www.mpo.cz/). Substituting it in the original relation (3) the cost of equity capital is calculated out.

$r_{e1999} = 7.6\% + 1.07 \times 7\% = 15.07\%$
$r_{e2000} = 6.5\% + 0.70 \times 7\% = 11.42\%$
$r_{e2001} = 6.3\% + 0.73 \times 7\% = 11.38\%$

Build up Model – Using INFA Model

The cost of capital is calculated here by using the relation (4). Every year the risk-free surcharge was the highest. Cost of capital was considerably influenced by the surcharge in small size company, which, in the case of INFA model (2), is characterized by the amount of equity capital. The surcharge for trading risk was the highest in the year 2000 when a low ROA was reached. The surcharge for financial stability was zero thanks to high liquidity of the company. The decreasing indebtedness contributed to gradual decrease of the surcharge for financial structure.

$r_{e1999} = 7.6\ \% + 4.28\ \% + 1.38\ \% + 0\ \% + 3.51\ \% = 16.77\ \%$
$r_{e2000} = 6.5\ \% + 4.23\ \% + 4.08\ \% + 0\ \% + 2.59\ \% = 17.40\ \%$
$r_{e2001} = 6.3\ \% + 4.21\ \% + 2.20\ \% + 0\ \% + 1.74\ \% = 14.45\ \%$

Calculation on the Basis of Risk Analysis

For the purpose of this calculation we estimate the trade risk at 6 per cent. This is because, the company operates in a branch of industry with relatively stable sales so far, but it has got problems in realizing satisfactory rate of return [3]. Financial risk is low (2%), the company uses mainly its own equity sources for its finance and its financial situation is good. The premium for trade and financial risk is added to the risk-free interest rate, and thus the cost of equity capital is obtained.

$r_{e1999} = 7.6\% + 6\ \% + 2\% = 15.6\%$
$r_{e2000} = 6.5\% + 6\ \% + 2\% = 14.5\%$
$r_{e2001} = 6.3\% + 6\ \% + 2\% = 14.3\%$

Dividend Model

Granitol company does not pay dividends every year, and for this reason this method cannot be used.

Average Profitability in the Branch of the Industry

The joint stock company ranks among companies working in rubber and plastics industry. Information on average profitability in this branch of industry can be obtained from http://www.mpo.cz/.

$r_{e1999} = 12.62\%$
$r_{e2000} = 12.61\%$
$r_{e2001} = 8.55\%$

Derivation of the Cost of Equity Capital from the Cost of Debt

In case of the analysed company the real cost of debt can be found out as a ratio between the cost interests and the amount of bank credits in individual years, to which a surcharge of 2.5 per cent is added [3]. The resultant value of the cost of equity capital is mentioned below.

$r_{e1999} = 8.85\% + 2.5\% = 11.35\%$
$r_{e2000} = 12.11\% + 2.5\ \% = 14.61\%$
$r_{e2001} = 10.81\% + 2.5\% = 13.31\%$

As different results are obtained in different methods, it is either possible to choose a method most suitable to fulfil the objective or to calculate arithmetic average or weighed arithmetic average where certain weights will be matched to the results of individual methods. It is also evident that the method in use influences the calculated cost of capital and thus the EVA (see **Tables 1** and **2**). In spite of the different EVA, which was influenced by the different methods of calculation of cost of equity capital, it can be said that Granitol a.s. did not create economic value in any of the years observed. The most suitable method for the conditions of the Czech Republic (owing to insufficiently liquid capital market) seems to be the build up method. Stressing the risks connected with the concrete company (size of the company, its financial stability, etc.) Another suitable method that can be used in practice is the CAPM with alternative estimates of beta. The other methods should be used only as complementary criteria.

3 Capital Structure and Economic Value Added

The growth of debt increases the owners' risk, as their demands are satisfied only after all the other liabilities have been paid. The growth of the debt burden increases the risk of insolvency. At the same time, increasing the debt in capital structure, the financial leverage can be used. For this reason, changes in the ratio between the debt and the equity capital influences the cost of individual sources of capital and WACC and thus the reached amount of the economic value added.

TABLE 1: VALUE OF INPUT FOR CALCULATION OF EVA

in thousand CZK	*1999*	*2000*	*2001*
NOPAT	***19 081***	***21 496***	***14 928***
Equity (E)	***316 044***	***333 952***	***339 270***
Debt (D)	***154 770***	***134 105***	***112 605***
Capital (E+D)	***470 814***	***468 057***	***451 875***

TABLE 2: CALCULATION OF COSTS OF CAPITAL AND EVA

Methods of Calculation of r_e	*Year*	r_e	r_d	*WACC*	*EVA (in th. CZK)*
CAPM	*1999*	***15.07%***	***5.75%***	***12.01%***	***-37 464***
	2000	***11.42%***	***8.36%***	***10.54%***	***-27 837***
	2001	***11.38%***	***7.46%***	***10.40%***	***-32 067***
Build-up method	*1999*	***16.77%***	***5.75%***	***13.15%***	***-42 831***
	2000	***17.40%***	***8.36%***	***14.81%***	***-47 823***
	2001	***14.45%***	***7.46%***	***12.71%***	***-42 505***
Risk analysis	*1999*	***15.60%***	***5.75%***	***12.36%***	***-39 112***
	2000	***14.50%***	***8.36%***	***12.74%***	***-38 134***
	2001	***14.30%***	***7.46%***	***12.60%***	***-42 008***
Average profitability	*1999*	***12.62%***	***5.75%***	***10.36%***	***-29 695***
	2000	***12.61%***	***8.36%***	***11.39%***	***-31 816***
	2001	***8.55%***	***7.46%***	***8.28%***	***-22 487***
r_e derived from r_d	*1999*	***11.35%***	***5.75%***	***9.51%***	***-25 693***
	2000	***14.61%***	***8.36%***	***12.82%***	***-38 509***
	2001	***13.31%***	***7.46%***	***11.85%***	***-38 619***

3.1 Possible Alternatives of Financing – Example of Granitol, a.s Company.

The data from Granitol were used again to evaluate the influence of the financial leverage upon EVA. Here we came out from the real situation of the company. Moreover another three alternatives for financing the company were simulated. In the first two alternatives, we gradually replaced most of the bank credits with equity capital. However, in the third alternative, we replaced a part of equity capital with bank credits in such an amount that the company could be able to pay cost interest from its EBIT and thus the increased indebtedness would not threaten its existence.

From **Table 3** it is found that, in the existing situation of the company as well as at other three alternatives of financing, negative value of economic value added is reached.

Let's have a look at how individual elementary factors (NOPAT, WACC, C) influenced the value of EVA at individual alternative financing.

3.2 Change of Elementary Factors Influencing EVA at Individual Alternatives of Financing

A: WACC

The most useful method related to objective was used to calculate the cost of equity (r_e) - build up method. The lowest average costs of capital is reached in the case when the value of the equity capital increases to 90% of all capital. Contrary to that the highest average cost of capital is reached at higher indebtedness. The higher cost at higher indebtedness was resulted by higher surcharge for the increased trade risk and financial structure.

There was only a change in WACC due to the different capital structure. The change in this elementary factor influences the amount of Economic Value Added. As we can see on the Figure 3, the increasing indebtedness from 0 to 10 per cent (decreasing WACC) resulted in positive influence upon EVA. Futher increase of the indebtness resulted in WACC increasing and had negative influence upon the EVA.

TABLE 3: CALCULATION OF EVA FOR POSSIBLE ALTERNATIVES OF FINANCING

		Build-up Method		For EVA = 0
Real Situation	**Indebtedness (debt/capital)**	**WACC**	**EVA**	**NOPAT**
1999	33%	13.15%	-42 831	61 912
2000	29%	14.81%	-47 823	69 319
2001	25%	12.71%	-42 505	57 433
Equity Capital Increase	**Indebtedness (debt/capital)**	**WACC**	**EVA**	**NOPAT**
1999	0%	12.33%	-38 970	58 051
2000	0%	12.36%	-36 356	57 852
2001	0%	10.96%	-34 598	49 526
Equity Capital Increase	**Indebtedness (debt/capital)**	**WACC**	**EVA**	**NOPAT**
1999	10%	11,97%	-37 275	56 356
2000	10%	11,86%	-34 016	55 512
2001	10%	10,63%	-33 106	48 034
Equity Capital Decrease	**Indebtedness (debt/capital)**	**WACC**	**EVA**	**NOPAT**
1999	39%	14.40%	-48 716	67 797
2000	35%	15.06%	-48 993	70 489
2001	31%	13.10%	-44 268	59 196

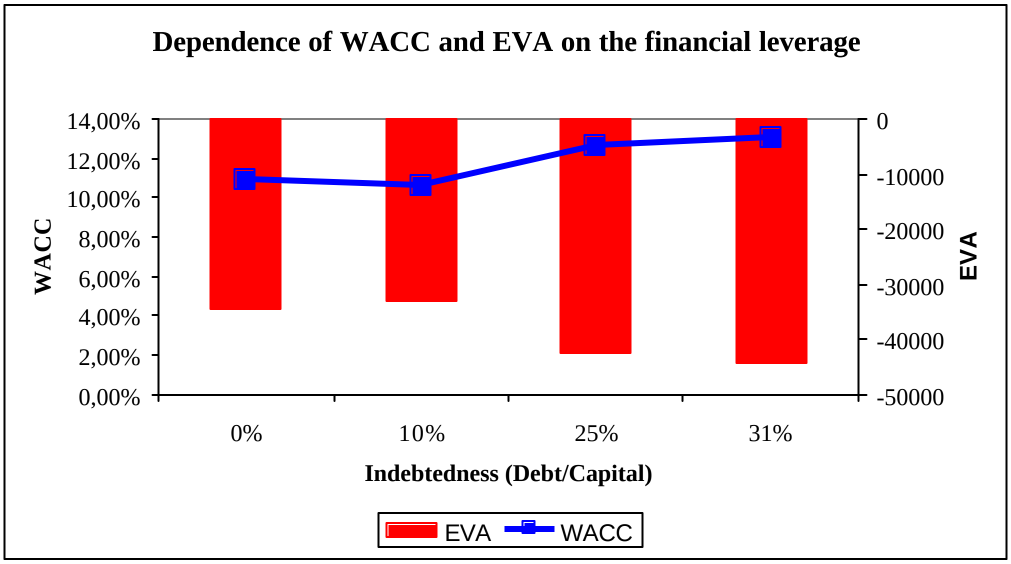


FIGURE 3: DEPENDENCE OF EVA ON THE FINANCIAL LEVERAGE IN 2001

B: NOPAT and Capital

Change in capital structure does not influence either the value of NOPAT or the amount of capital (C) on which interest is paid.

However, it is interesting to note that, for the analyzed company, the priority should be to increase the efficiency. If NOPAT is insufficient (as it is in the case of the analyzed company), even good capital structure will not save anything. A considerable increase in NOPAT is the main prerequisite for successful performance of the company. We calculated the amount of NOPAT for individual alternatives of financing which should have been achieved by company´s activities to reach EVA=0 (see **Table 3**).

References

Contact the author for a list of references.

End Notes

Cost of capital, as a measure of company effectiveness, influences the amount of Economic Value Added in a considerable way. Determination of the cost of equity capital is linked with many problems. In countries where the capital market is developed, CAPM can be used. Under conditions of non-liquid capital market, the most suitable method seems to be the build up method. Another applicable model could be CAPM with alternative estimation of beta. The results also show, using a concrete example, how the capital structure influences the cost of capital. In spite of the fact that the capital structure plays an important role in financial management of the company, even a suitably chosen capital structure will not help when the profitability of the company is insufficient.

Location Advantages of the Mid-West China and Types of Foreign Direct Investment Targeted

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Abstract

The positive effects of FDI on the economic development of the hosting country are not generated automatically with the arrival of FDI. Instead, the realization of the potential positive effects is determined to a large extent by the types of foreign direct investment and the matching of domestic investment environment. This paper briefly reviews theories on the effect of technology disparity between the hosting country and the investing country on FDI, discusses types of FDI that Mid-west China should target based on its location comparative advantage, and proposes specific measurements for promoting targeted FDI.

Introduction

The mainstream research on multi-national investment has always focused on the behavior of multi-national companies since S. Hymer's innovative study on FDI (Foreign Direct Investment) in 1960. The location advantage of a hosting country is considered only as a constraining factor in cross-national investment from prospect of transnational corporations.

The benefit that the hosting country seeks in cross-national investment may be quite different from that of multi-national companies; therefore their explanations of "Location Advantage" may be different as well. The location advantage of the hosting country needs to be constructed such that it attracts foreign investment and maximizes the benefits of foreign investment on the hosting country. In another words, the positive effects of FDI on the economic development of the hosting country are not generated automatically with the arrival of FDI. Instead, the realization of the potential positive effects is determined to a large extent by the types of foreign direct investment and the matching of domestic investment environment.

Introducing FDI is expected to be of great importance in China's "Great Western Development Strategy". However, the positive effects and the magnitude of the effects of FDI on the economic development of the region are closely related to the matching of FDI and local investment environment including government policies. While it is important to have government policies that attract and encourage FDI, it is as important that we analyze types of FDI according to local comparative advantage and development vision and ping down those that can help develop regional economy the most. This paper analyzes in theory the effect of technology disparity between the hosting country and the investing country on FDI, discusses types of FDI that can be attracted to the Mid-west China based on its location comparative advantage, and proposes specific measurements for promoting FDI.

I. The Impact of Technology Disparity between the Hosting and Investing Countries on Technology Advancement of the Hosting Country

Many researchers show the effect of technology spillover of FDI, which promotes technology advancement of the hosting country (Caves, 1974; Globerman, 1979; Blomstrom & Persson, 1983). However, the effect of technology spillover of FDI is not materialized automatically. Its realization depends on many economic and technological factors. Findlay (1978) built a model of transferring technology from developed countries to developing countries, suggesting that the technology disparity between the hosting country and the investing country is positively related to economic growth brought by technology spillover. That is, the bigger the technology disparity, the larger the potential space for the imitation of technology by the hosting country, thus faster economic growth. In contrast, Lapan and Bradhan (1973) argued that if the technology disparity between the hosting country and the investing country is too big, it may very well become an obstacle to technology disperse, reducing the potential benefits of FDI to the hosting country. Large disparity in technology suggests large differences in economic development, income level and consumption level. The technology of developed countries may not be appropriate for developing countries at their stages of economic development, obstructing the transfer and disperse of advance technology.

Luiz (1999) argued that the effect of FDI on technological advancement and economic growth is not directly dependent on the absolute disparity in technology between the hosting country and the investing country. The technology brought by FDI affects technological advancement and economic growth in hosting countries through different venues in different countries. For example, investment between OECD countries usually brings in new technology that substitutes the old one. Technology is dispersed and promoted through substituting less efficient technology with more efficient technology. Instead, FDI by OECD countries in non-OECD countries usually brings in technology that coexists and complements with local existing technology. There are two explanations for the above difference. One is that developing hosting countries usually lack the capacity to digest and absorb advance technology brought by FDI, which integrates slowly with or even becomes independent of local technology. As a result, developing hosting countries cannot take full advantage of the new technology brought by FDI. In worse cases, it may lead to reinforcement of "duality" in developing hosting countries. Another explanation is that multi-national companies do not provide advance technology on the bases of the hosting country's trade protection and the stages of life cycle of local industries. Instead, aiming at industries that have a limited production capacity but a rapid increase in demand, parallel technology is provided to rapidly increase production and take over market shares, which coexists and complements with the local technology. In fact, factor endowment of the hosting country is one of the factors that determine FDI. Thus the complementarities between foreign technology and local technology are indeed one of the important factors that attract FDI, at least in the short run. Because of the complementarities, local technology is able to continue to survive and even becomes more profitable due to the cooperation of technology brought by FDI. The co-movement and integration of foreign technology and local technology will be able to accelerate technological advancement and extend production possibility frontier in the hosting country.

Based on the above analyses, we can infer that: if FDI brings along technology that is much more advanced than that in the developing hosting country, it is possible for the hosting country to skip over some stages of technological development and adopt advance technology directly. However, since the technology brought by FDI is much higher than the average technology in the hosting country, which means it lacks the necessary support of exterior technology, foreign investment with high technology may be separated from the local technological system and contribute little to the local technological progress. If FDI brings along technology that complements, coexists, and integrates with the local technology, it is probably more reliable to produce positive effects on local technological development. Therefore the hosting country needs to choose FDI with different levels of technology according to an industry's developmental stage and its need for technology.

II. The Analysis of Regional Conditions of the Mid-West for FDI

Industrial development and regional conditions of the Mid-West of China is markedly different from those of the East coastal region. The successful story of the East in attracting FDI cannot be copied directly by the Mid-West. In addition, the Mid-west covers a vast amount of area with large differences in many respects within the region. Therefore, the Mid-west region needs to exam its specific industrial and other regional conditions and chooses FDI with different level of technology that forms differential co-movement with local technology and enterprises. The developmental stages of industries and technological structure of industries in the Mid-west region could be characterized as follows:

Sparsely industrialized, the Mid-west region will continue to target FDI that invests in the manufacturing sectors.

On average, China has entered the accelerated stage of industrialization. However, the degree of industrialization is uneven, decreasing gradually from the East region to the West region. The economic reform has led to speedy development of manufacturing industries in the East region, widening the disparity in industrialization between the East and the Mid-west region. The tertiary Industry is in the high mode of development in the East region, while the Mid-west region is still in the accelerated stage of manufacturing industry development. Continued industrialization and structural changes in manufacturing sectors will be the driving force in the economic development of the Mid-west. Absorbing investment, especially FDI, needs to target the manufacturing sectors, accelerating industrialization by increasing the amount of investment and by adjusting sectoral structure. In addition, the Mid-west has a rich endowment of agricultural resources. The primary industry, which has a hefty presentation in its economy, can realize its huge potential by introducing FDI and adopting advance technology.

Similarity in industrial structure has reduced in the Mid-west, with increased differences in sub-regional advantages.

Similarity in industrial structure has been reduced in China since 1990. Structural changes in industries have led to increases in specialization and decreases in the similarity in industrial structure.

According to calculations of specialization indices[i] on the total production value of the 31 industries of all provinces/cities in the Mid-west China (table 1), specialization indices on industrial structure increase in all provinces except for Chongqing, Shangxi and Tibet, where the data for Tibet were unavailable. Some have also improved their rankings nation-wide.

The overall structure of the three industries (primary, secondary, tertiary industries) has improved and the similarity in secondary industry structure has gradually reduced among different regions with the reduction most noticeable in the Mid-west region. During the years of 1992-1997, the index that measures the similarity in industrial structure[ii] declined in 18 provinces/cities in China, among which were all provinces with data available in the Mid-west region. Yunnan and Shangxi provinces experienced relatively bigger decline in the similarity index, with 5% and 3.36% respectively.

TABLE 1: INDUSTRIAL SPECIALIAZATION INDEX FOR MID-WEST PROVINCES

1990		1999		1990- 1999	
Ranking	Specialization Index	Ranking	Specialization Index	Ranking	Change(%)
3. YUNNAN	22.30	1. YUNNAN	33.44	1. GUANGXI	41.64
6. NINGXIA	21.21	3. QINGHAI	30.56	3. QINGHAI	38.03
7. XINJIANG	20.84	4. GUANGXI	30.04	7. SHANXI	28.53
10.CHONGQI	18.27	7. XINJIANG	25.39	8.	28.11
N	17.76	8. .INNER	23.70	.CHONGQIN	26.38
12.GUANGXI	17.67	MONGOLIA		10. NINGXIA	25.84
13.INNER		10. NINGXIA	22.15	11.SICHUAN	24.63
MONGOLIA	17.60	11.GUIZHOU	21.83	14.GUIZHOU	23.18
14.GUIZHOU	17.48	13. GANSU	20.44	19. .INNER	
15.GANSU	17.36	14.SICHUAN	17.18	MONGOLIA	21.17
17.QINGHAI	16.19	21.CHONGQI	16.81	24. YUNNAN	20.54
19.SHANXI	13.62	N	14.12	27. GANSU	20.05
25.SICHUAN		25.SHANXI		28.XINJIANG	

Source: calculated based on total production value of industrial sectors (1990 price) provided by National Statistical Bureau.

TABLE 2: CHANGES OF SIMILARITY INDEX FOR PROVINCES (1992-1997)

Ranking		Similarity Index (%) 1992	Similarity Index (%) 1997	Change (%)
1.	BEIJING	73.40	64.16	- 9.24
2.	YUNNAN	92.82	87.82	- 5.00
3.	JILIN	97.19	93.63	- 3.56
4.	SHAANXI	98.04	94.68	- 3.36
5.	ZEJIANG	95.65	92.50	- 3.15
6.	HENAN	98.71	95.76	- 2.96
7.	ANHUI	97.96	95.05	- 2.91
8.	GUANGXI	97.06	94.19	- 2.88
9.	GUANGDONG	96.26	93.44	- 2.82
10.	SICHUAN	98.80	96.10	- 2.71
11.	GANSU	97.30	94.86	- 2.44
12.	GUIZHOU	95.86	93.55	- 2.31
13.	JIANGXI	96.96	94.68	- 2.27
14.	QINGHAI	94.38	92.26	- 2.12
15.	XINJIANG	91.82	89.88	- 1.94
16.	NINGXIA	97.53	96.23	- 1.30
17.	SHANDONG	99.37	98.23	- 1.14
18.	FUJIAN	98.18	97.52	- 0.66
19.	HEBEI	97.30	97.32	0.02
20.	SHANXI	78.76	78.94	0.18
21.	HUBEI	98.08	98.45	0.37
22.	HUNAN	93.99	94.77	0.78
23.	HEILONGJIANG	82.86	84.97	2.11
24.	JIANGSU	93.85	96.06	2.21
25.	TIANJIN	75.40	79.27	3.87
26.	LIAONING	91.08	95.74	4.66
27.	SHANGHAI	58.93	67.70	8.77
28.	INNER MONGOLIA	-	93.88	-
29.	CHONGQING	-	94.21	-

Source: calculated based on data in "China's Input & Output Table"1992, 1997, data for Hainan and Tibet are not available. The increases in specialization in the Mid-west region suggest the increases in the differences of location comparative advantage and competitive advantage among sub-regional areas. To develop specialized economy in sub-regions, it is important to attract FDI that targets different industries and FDI with different investment vehicles.

There is a relative over-supply of traditional industries in the Mid-west.

The Mid-west region is much more richly endowed with natural resources than the East region. Traditional industries primarily focus on exploring and processing of natural resources, such as mineral processing, and machinery manufacturing. Traditional technology accounts for a large percentage in the structure of production technology with a small percentage of advance technology. The Mid-west region is also richly endowed with agricultural resources. It needs to emphasize FDI that will help the region's specialized agricultural products and processed high value-added agriculture products.

The resource-intensive industries gradually lose their traditional advantage with products over-supplied during changes of economic structure and changes in supply-demand relationship that come along with economic growth. Such traditional industries lose their steam in propelling the growth of the economy, leading to greater disparity in economic growth between the Mid-west region and the East coastal region. As China's manufacturing industry becomes more and more balanced between heavy industries and consumer industries, self-sufficiency within the heavy industries has been corrected (which were the dominant feature of China's industrial development pattern).

In addition, since the opening of China's markets, prices of many resource-intensive products begin to reflect those of the international markets, which make supply greater than demand in primary industries in the Mid-west such as coal, steel, petroleum. Primary industries in the Mid-west have gradually reduced their impact on economic growth. According to Sun Jiuwen's calculations (1999) of the impact of industries with strong comparative advantages on economic growth in 1986-1990, and 1991-1995, the index that measured the impact grew rapidly for the three provinces in the East region (Jianshu, Shandong and Guandong provinces), indicating strong propelling effect of the industries which enjoy comparative advantages on economic growth. However, the index for the four provinces in the Mid-west (Hunan, Shangxi, Guazhou, and Shangxi provinces) for the same periods declined gradually, indicating that the weakening of their primary industries was hindering the growth of the region.

The adjustment of economic structure in the Mid-west is badly needed. To revitalize old primary industries, the Mid-west region needs to take advantage of advance technology and develop in-depth processing of resource-intensive products with high added values. In addition, new primary industries should be identified and developed according to the trend of development of industries and technology in the world. In both cases, FDI that brings in advance and appropriate technology will be indispensable.

The adjustment of ownership structure in the Mid-west is lagging behind relative to the East region.

Due to both historical reasons and the delay of economic reform, the structure of ownership in the Mid-west is vastly different from the East coastal areas. State-owned enterprises account for a much larger percentage in the economy in the Mid-west than in the East region. In general, non state-owned enterprises in the Mid-west also have a smaller scale than those in the East.

The relative delay in the development of non state-owned economy has constrained the progress in market economy, technological innovation, and structural adjustment in the Mid-west. Introducing FDI to the Mid-west will accelerate the adjustment of ownership structure and help develop enterprises with different technology needs through competition and collaboration.

Foreign Funded Enterprises can form strategic coalition with state-owned enterprises of mid to large size. Instead, mid to small size state-owned enterprises can be reshaped by FDI through acquisition and merger. Therefore, some state-owned enterprises can compete and coexist with the foreign enterprises, while some others can become local suppliers of foreign enterprises, benefiting from the so-called backward linkage of FDI.

III. What types of FDI to attract in the Mid-west?

The analyses above show the impact of technology disparity between the investing country and the hosting country on technology advancement and economic growth of the hosting country, and the regional conditions for industrial development in the Mid-west. Based on these analyses, in addition to encourage investment in the much needed infrastructure, the Mid-west region needs to attract FDI to traditional and related industries that have a large amount of existing enterprises, and to new industries with high technology that can promote leap-frogging growth of the Mid-west.

Attracting FDI to traditional and related industries.

Traditional industries in the Mid-west are resource-intensive industries such as mineral processing,, and machinery manufacturing, resource intensive chemical industry, etc.. The similarity in industrial structure within the region has observably reduced since 1990. Specialization is enhanced, resulting in increased differences in industries with comparative advantage in different provinces/areas. A 1997 study (Lu Zhongyuan) shows that agriculture is one of the industries with top comparative advantage in all 12 provinces/cities in the West

With limited industrialization, agriculture weights heavily in the economy of the Mid-west. It has heterogeneous geography with large variance in climate, which provides potential advantages for specialized agriculture. However, with lagging production technology, productivity in agriculture is low. Therefore, to develop specialized agriculture, the Mid-west should actively attract FDI and adopt modern production technology and processing technology in agriculture.

In addition, production line should be extended to processing industries in an effort to increase added values to products and industrialize traditional agriculture.In the same study, the second industry was also analyzed for comparative advantage in the Mid-west. Each province proved to hold its own comparative advantage in different sectors. Such that each province/city should attract FDI of different types based on its specific resource advantages and industries with comparative advantage.

FDI that uses resource intensively and FDI that refines resources

The Mid-west needs to attract users of local specialized resources to build production site near local resource sites. This can reduce transportation costs due to insufficient transportation infrastructure in the Mid-west. This can also form supply linkage with local resource suppliers, so-called backward-linkage, so as to help develop local enterprises that produce resources. The Mid-west also needs to attract foreign direct investment of in-depth processing of resources that are specific to the local and that have comparative advantage. It can choose products whose technology is easily transferable and products that have large domestic market demand and can substitute imports directly, such as high-quality dairy food, organic agricultural products that are specific to local, flowers, fruits, herbs, … etc. Because of its low capital demand, this type of FDI is easier to attract; because its technology is easily transferable, such FDI can take advantage of local conditions faster and set up standards of products similar to the international market; most importantly, this type of investment can meet different demands for the domestic market and the international market and increase exports by using foreign investors' existing marketing venue.

This type of resource-oriented FDI can form strong complementarity with local production capacity, which can survive and grow due to the larger market brought by foreign investment. The local production technology can also be improved by inflow of visible or invisible assets transferred from the foreign-invested enterprises. For example, in order to acquire important resources with high quality, some foreign-invested enterprises are willing to provide technical help to some local suppliers to up grade their production.

This type of FDI will help traditional industries to survive and construct new industries with comparative advantage in the Mid-west. In addition, strengthening of supply linkage between foreign-invested enterprises and local enterprises will help tighten the integration of foreign economy and local economy.

FDI that invests on up-stream industries, which provide inputs for industries with comparative advantage.

FDI can also positively affect local production and technology through forward linkage. That is to attract FDI on up-stream industries, especially those for industries with comparative advantage, such that input supply can be improved both qualitatively and quantitatively for industries with comparative advantage. The localization of input production can reduce production costs and increase market competition for the industries with comparative advantage. Direct investment and local production and marketing can also help foreign investors to take up market shares and keep up their competitive advantage. For example, the development of specialized agriculture in the Mid-west will create a strong demand for high-quality animal food, fertilizer and other agriculture backup products.

Encouraging foreign investment on industries with potential market demands and industries that affect economy widely and deeply will help develop local down-stream industries with comparative advantage and enhance the quality of their products. Due to its characteristic of large production scale and its position on the production chain, this kind of up-stream industries need to attract big foreign investment with strong backup for capital and technology. Such FDI should provide production technology much higher than domestic technology and have strong R&D capacity such that production technology can be improved and innovated and such FDI can affect down-stream industries through backward linkage and spill over effect.This type of FDI can also help reorganize and develop local small and medium size enterprises.

More and more multi-national companies have tried to focus on enhancing their main production capacity while subcontracting exterior products and processing, so called outsourcing, to reduce burden and increase flexibility. Large-scale FDI on up-stream industries is likely to partnership with local reputable small and medium enterprises and provide needed technological support with or without cost. These local enterprises will become alliance with multi-national companies.

FDI on high-tech industries.

In addition to attracting FDI on industries with comparative advantage, the Mid-west needs to create competitive advantage to realize "late-comer advantages". Although technology development in the Mid-west is on the week side in general, some metropolitans such as Xian, Chengdo, Chongqing and their neighboring areas are among the front-runners of technology development.

With many colleges, universities and research centers, these metropolitan areas have better supply of human resources than other areas and have started to become focus areas for knowledge-intensive and technology-intensive industries such as electronic information, airplane and air-space, electronic machines, pharmaceutical industry, and gene engineering. Based on the developmental trend of high-tech industries, the Mid-west should attract FDI on such industries to effectively increase the chance for leap-frogging development.

The specialization between the East region and the Mid-west region should focus not only on orthogonal or ladder but more on parallel specialization such that the disparity in economic growth between the West and the East can be shortened and more balanced development between the two regions can be achieved. The Mid-west region should attract FDI on industries that bring in technology that is much more advanced than local technology.

This can strengthen the propelling effect on local technological development, help develop pillar industries that promote economic growth in the Mid-west, and reduce its technological disparity with advance technology in the world, taking full advantages of late comers'.

Conclusion

Introducing FDI is expected to be of great importance in China's "Great Western Development Strategy". But the realization of the potential positive effects of FDI is determined to a large extent by the types of foreign direct investment and the matching of domestic investment environment. If FDI brings along technology that is much more advanced than that in the developing hosting country, it is possible for the hosting country to skip over some stages of technological development and adopt advance technology directly.

However, since the technology brought by FDI is much higher than the average technology in the hosting country, which means it lacks the necessary support of exterior technology, foreign investment with high technology may be separated from the local technological system and contribute little to the local technological progress. If FDI brings along technology that complements, coexists, and integrates with the local technology, it is probably more reliable to produce positive effects on local technological development.

Therefore the hosting country needs to choose FDI with different levels of technology according to an industry's developmental stage and its need for technology. Based on the above judgments and brief investigation of local advantages in Mid-west china, two types of FDI should be targeted to serve development needs from different perspective: Attracting FDI to traditional and related industries FDI to high-tech industries.

The former aims to materialize strengthen and renew local comparative advantage, while the later focuses on technology leap-frogging development. To promote FDI of targeted types, local governments are supposed to pursue at least two measures: Firstly, to specify regional and sub-regional comparative advantages, thus to clarify specific industries and sectors which by inflow of FDI are most likely to spur local development; Secondly, to help establishing linkages between local and foreign invested enterprises. The positive effects of FDI in the end have to be realized through either "spill over" effect or "following the leader" effects, both require the integration of local economy and foreign invested activities. The integration could be in many different forms such as competing, complementing, collaborating, alliance, etc.

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End Notes

1.

$$H = 100 \times \left(1 + \frac{\sum_i s_{i*} \ln s_i}{h_{\max}}\right)$$

H is specialization Index, which takes value from 0 to 100, S_i refers to Similarity index. H takes value of 0 when sectors are evenly distributed, when there is one sector in the economy, H takes value of 100. The higher the index, the higher the specialization is.

2. Similarity Index reveals the degree of similarity between a region's industrial structure and the national industrial structure.

$$\mathbf{Si} = \sum X_{ij} \overline{X}_j / \left(\sum X_{ij}^2 \sum \overline{X}_j^2\right)^{(1/2)}$$

Si refers to the similarity index of region i, X_{ij} refers to the share of industry j in region i, $\overline{X}_j$ refers to the national share of industry j.

Are Global Equity Markets Becoming More Correlated?

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Abstract

This paper examines the correlation coefficients between the US and other eight equity markets over a 30 year time period. The time series of yearly correlation coefficients based on the monthly data shows no statistical evidence that the global equity markets were becoming more correlated over time, either among developed markets or between developed and emerging markets. The findings contradict some of the recent empirical studies. There are two important implications of the findings. First, international diversification is still beneficial despite an increasing amount of literature suggesting more integrated world equity markets. Second, the market rotation is the key to diversification.

Introduction

In recent years, an increasing amount of literature has suggested that the benefits of international diversification have diminished. Specifically, two factors generally have increased the correlation among the various markets, particularly among the equity markets. One factor is so called crisis mentality, which drives investors bearish almost simultaneously [Faboozi & Modigliani, 2003]. The second factor is that the global sectors tend to follow the global market for their goods and services rather than their local economy. This is also referred to as the industry factor [Cavagia, Brightman & Akid, 2000] or sector effects [Baca, Garbe, & Weiss, 2000]. Some empirical studies illustrate the increasing correlation in the world equity markets. Harrinton [2003] uses 3-year, 5-year, 10-year, 14-year, and 30-year time periods and shows an increasing correlation between S&P 500 and MSCI EAFE, and S&P500 and IFCI Emerging Composite.

There are three research questions we need to answer. First, the correlation coefficients between various equity markets are increasing or decreasing over time? Or they are simply unstable and trendless? Second, do developed vs. developed and developed vs. emerging markets behave any differently? Finally, what are the implications of these empirical results?

Methodology

The correlation coefficients of the US and eight equity markets are examined over the time period between 1973–2002 (subject to the data availability of some markets). The eight markets are UK, Germany, France, Canada, Australia, Japan, Korea, and Mexico. These markets cover four major continents, and both developed and emerging markets.

First, the yearly correlation coefficients are derived from the monthly data by using the Share Price Index of the International Financial Statistics. These data are in local currency, which effectively isolates the equity market performance from the currency performance. The results are eight sets of time series. Then each time series is plotted in a scatter, which provides an intuitive result. Finally, the trends are analyzed based on the scatters, and the statistical interpretations help us to conclude the study.

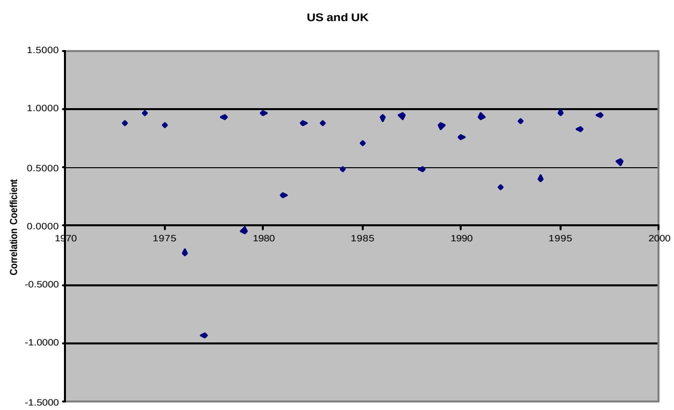
Major Findings

In general, there is no statistical evidence to support the hypothesis that the correlation coefficients between the studied equity markets are increasing, decreasing, or stable over time. In fact, no obvious patterns of these time series are observed. Each pair of the equity markets is examined as follows.

US and UK

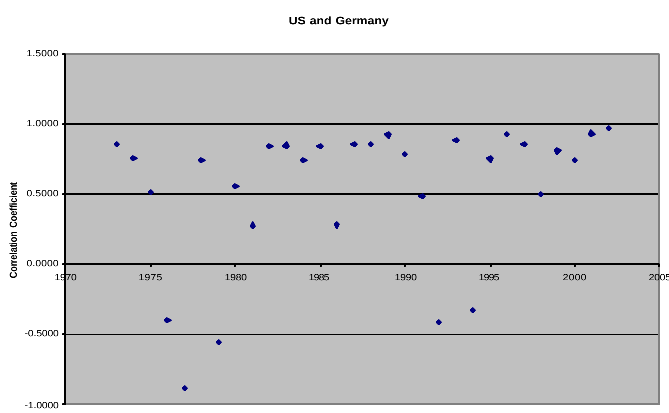
Intuitively, this is the only time series that shows a slightly increasing linear pattern. There are three negative coefficients occurring in 1976, 1977 and 1979. For most years, two markets are highly correlated. Unfortunately, for some reason the UK share price index data for 1999-2002 are missing in the database.Using the ordinary least squares (OLS) method, the fitted trend line has a positive slope of 0.015. P-value for the slope coefficient is 0.215 and R^2 is 0.06. P-value indicates the exact significance level associated with a particular testing result. In our testing, the null hypothesis states that the coefficient or slope is zero. Therefore, the probability of committing Type I error is 21.5%. Type I error occurs when we reject the null hypothesis which in fact is correct. At the commonly used significance level 5%, we certainly do not reject the null hypothesis, i.e. statistically speaking, the coefficient is zero. R^2 = 0.06 indicates that the explained variance of the correlation coefficients by this regression is only 6%, which is extremely low.

Therefore we have no statistical evidence that the correlation between the US and UK equity markets has been increasing over time.



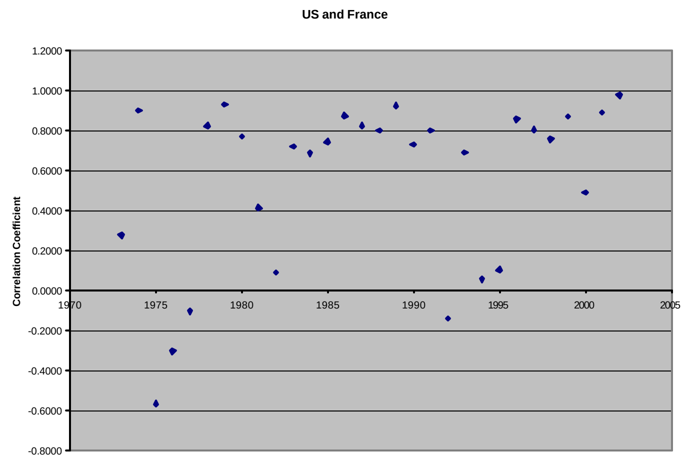
US and Germany

The linear pattern is not observed unless excluding all five negative correlation coefficients in 1970s and 1990s. An OLS trend line has a positive slope of 0.018 with a P-value of 0.094 and an R^2 of 0.097, which suggest a very weak fit. Therefore we have no statistical evidence that the correlation between the US and UK equity markets has been increasing over time.



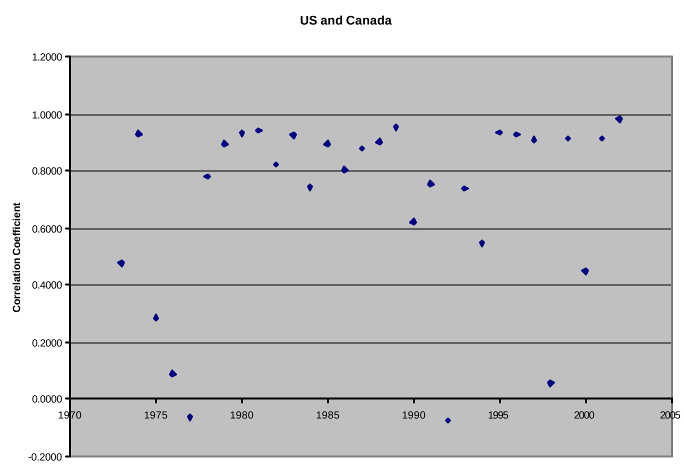
US and France

The linear pattern does not exist. An OLS trend line has a positive slope of 0.016 with a P-value of 0.061 and an R^2 of 0.12, which suggest a very weak fit. Therefore we have no statistical evidence that the correlation between the US and France equity markets has been increasing over time.



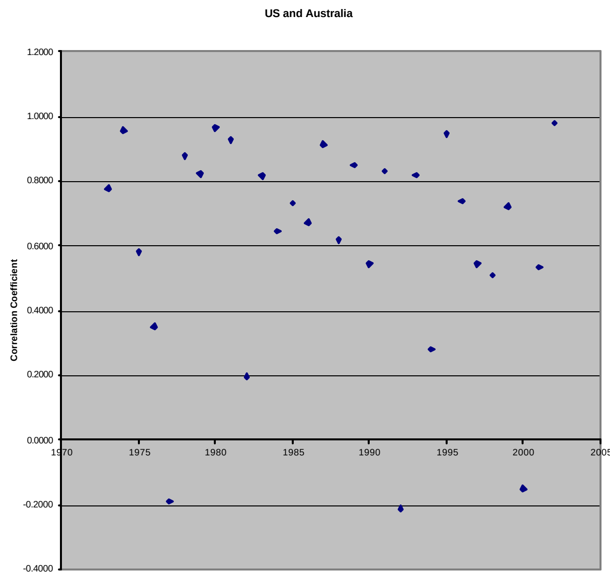
US and Canada

It is interesting to see that, Canada, as a very close trading partner with the US, does not show an increasing correlation with the US. An OLS trend line has a slope of 0.006 with a P-value of 0.392 and an R^2 of 0.026, which suggest a very weak fit. Therefore we have no statistical evidence that the correlation between the US and Canada equity markets has been increasing over time.



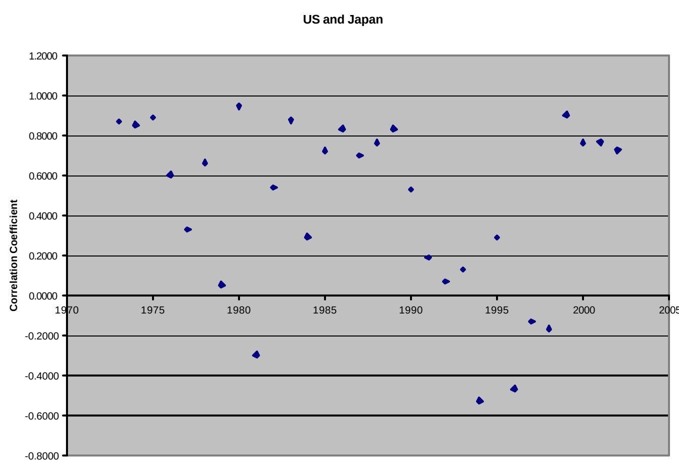
US and Australia

The linear pattern is not observed. Negative and low positive correlation occurred in 1970s, 1980s and 1990s. An OLS trend line has a negative slope of 0.004 with a P-value of 0.566 and an R^2 of 0.012, which suggest a very weak fit. Therefore we have no statistical evidence that the correlation between the US and Australia equity markets has been increasing over time.



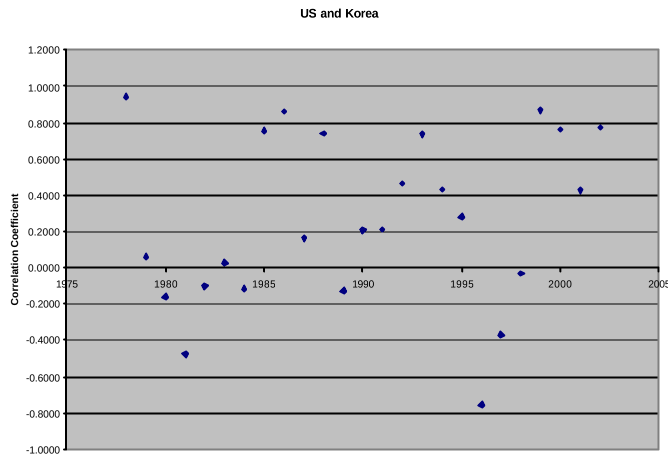
US and Japan

The linear pattern is not observed. There are four negative and four low positive correlation coefficients through 1990s. An OLS trend line has a negative slope of 0.014 with a P-value of 0.132 and an R^2 of 0.079, which suggest a very weak fit. Therefore we have no statistical evidence that the correlation between the US and Japan equity markets has been increasing over time.



US and Korea

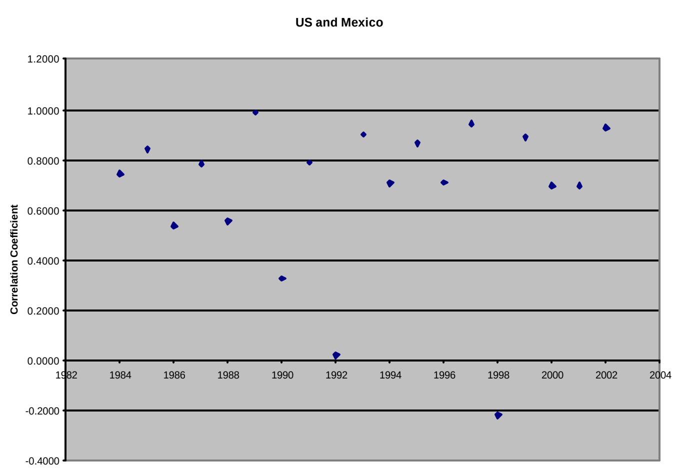
Korea, as an emerging market, has shown its very positive, very negative and low correlation with the US market over time. A linear pattern is not observed. An OLS trend line has a positive slope of 0.011 with a P-value of 0.395 and an R^2 of 0.032, which suggest a very weak fit. Therefore we have no statistical evidence that the correlation between the US and Korea equity markets has been increasing over time. The Korea share price index data are not available between 1973-1977 in the database.



US and Mexico

Mexico, as an emerging market and a close trading partner with the US, shows a fairly stable positive correlation with the US equity market if excluding those three low correlation coefficients in 1990, 1992 and 1998. An OLS trend line has a slope of 0.0003 with a P-value of 0.981 and an R^2 of 0.00003, which suggest a weak fit. Therefore we have no statistical evidence that the correlation between the US and Mexico equity markets has been increasing over time. The Mexico share price index data are not available between 1973-1983 in the database.

To compare the eight sets of time series, the study time period is divided into three sub-periods: 1973-1982, 1983-1992, and 1993-2002. Further, the correlation coefficients (r) are categorized in four groups: 1 ? r ? 0.5 (positive), 0.5 > r ? 0 (weak positive), 0 > r ? -0.5 (weak negative), and -0.5 > r ? -1 (negative). The following table records the occurrence of each category of correlation coefficients for each pair of markets in each sub-period. For example, the cell (6, 1, 2, 1) indicates that there is a positive correlation for 6 years, weak positive for 1 year, weak negative for 2 years and negative for 1 year between the US and UK equity markets during the sub-period of 1973-1982.



	US &UK	US & Germany	US & France	US & Canada	US & Australia	US & Japan	US & Korea	US & Mexico
1973-1982	6, 1, 2, 1	6, 1, 1, 2	4, 3, 2, 1	6, 3, 1, 0	7, 2, 1, 0	7, 2, 1, 0	1, 1, 3, 0	n/a
1983-1992	7, 3, 0, 0	7, 2, 1, 0	9, 0 1, 0	9, 0, 1, 0	9, 0, 1, 0	7, 3, 0, 0	3, 5, 2, 0	7, 2, 0, 0
1993-2002	5, 1, 0, 0	8, 1, 1, 0	7, 3, 0, 0	8, 2, 0, 0	8, 1, 1, 0	4, 2, 3, 1	4, 3, 2, 1	9, 0 , 1, 0

All pairs have positive or weak positive correlation in most years. But whether the correlation coefficients are increasing over time is ambiguous. Furthermore, positive correlation does not occur simultaneously for all markets if individual yearly coefficients are compared. For example, in 1981 the correlation coefficients are 0.94 with Canada and 0.93 with Australia; but –0.30 with Japan, -0.48 with Korea, and 0.26 with UK. Similar situations exist in other years.

We may also want to compare the average correlation coefficients for each sub-period. They are compiled in the following table:

	US & UK	US & Germany	US & France	US & Canada	US & Australia	US & Japan	US & Korea	US & Mexico
1973-1982	0.4551	0.2700	0.3231	0.6090	0.6262	0.5476	0.0537	n/a
1983-1992	0.7298	0.6187	0.6979	0.7408	0.6408	0.5838	0.3185	0.6200
1993-2002	0.7662	0.7027	0.6501	0.7373	0.5917	0.2295	0.3128	0.7113

It is evident that the average correlation coefficients have increased for all pairs from 1973-1982 to 1983-1992. However, the results are mixed from 1983-1992 to 1993-2002. The UK, Germany and Mexico show increased average correlation coefficients with the US, while other five markets show decreased correlation, particularly Japan. The popular argument that the global economy is becoming more integrated does not justify that the global equity markets are becoming more correlated.

In addition, the compiled data show the six developed markets behave differently with the US market and so do the two emerging markets.

Conclusions

The correlation coefficients between the US equity market and other eight equity markets have been examined over a 30-year time period. The time series of yearly correlation coefficients based on the monthly data shows no statistical evidence that the global equity markets were becoming more correlated over time, either among developed markets or between developed and emerging markets.

As mentioned in the introduction section, some empirical studies illustrate the increasing correlation in the world equity markets and the proponents use industry factor or sector effects to explain the results. Interestingly, we may also use the same explanation for the different empirical results shown in this paper.

It is a well-known fact that each country's equity market has its own distinguished composition of industries or sectors. For example, the resource sectors such as metals and forest products in the Canadian equity market weigh much more compared to the US equity market. The industry or sector differences among countries will not necessarily diminish as the world economy becomes more integrated. Instead, specialization and comparative advantage may widen these differences in the future. As a result, the world equity markets may become less correlated. Of course, this is not to say that the equity market composition is the only underlying factor that will affect the correlation of the world equity markets. Identifying all relevant factors and examining their effects/interactions are not conducted in this paper.

There are two important implications of the findings. First, international diversification is still beneficial despite an increasing amount of literature suggesting a more integrated world economy. Indeed, the rapid growth in international trade and economic cooperation are integrating the world economy; cross-border listing/trading and other market activities are also integrating the world equity markets. However, the integration is a very long process and so far we have no evidence to conclude that it has resulted in an increasing correlation over time. Moreover, an increasing integration does not guarantee an increasing correlation among equity markets. Therefore the ample opportunities for diversification are still existing and will continue to exist for a very long time.

Second, the market rotation is the key to diversification. We have observed that positive correlation does not always occur simultaneously for all markets, despite sometime it does. This is also true for those markets with very close economic ties. Then the strategy is not simply a passive diversification. It is essential to identify the markets with weak or negative correlation within a certain time period. As a result, we need an active diversification strategy, particularly in the more dynamic future.

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Private Equity as a Driver for Growth in Central and Eastern Europe

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Abstract

Venture Capital and Private Equity have become a main driver of financing in mature capital markets. Making their way from the US to the UK in the first step, they are now widely used all over Europe and have rapidly found acceptance as an interesting alternative to debt financing.

Both equity instruments allow the investor to participate in the shareholding of the company, which results in a more active involvement in the day-to-day business or at least the main decisions.

Private equity provides equity capital to enterprises not quoted on a stock market. Private equity can be used to develop new products and technologies, to expand working capital, to make acquisitions, or to strengthen a company's balance sheet. It can also resolve ownership and management issues – a succession in family-owned companies, or the buyout or buy-in of a business by experienced managers may be achieved using private equity.

Venture capital is, strictly speaking, a subset of private equity and refers to equity investments made for the launch and early development of a business. Among different countries, there are variations in what is meant by venture capital and private equity. During the last years, the term venture capital is generally used for early stage investments, especially in the technology industry. However, for this paper we will use both terms interchangeably.

European private equity

The European venture capital industry can trace its roots back 50 years but growth started in earnest in the 1980s. It now provides the European private corporate sector with permanent access to professional sources of growth capital.

Key European market data

?? Since the emergence of private equity in Europe in the early '80s, a cumulative total of more than €160 billion of capital has been raised for investment in Europe's most promising growth companies

?? 41% of all investments are to provide expansion finance

?? Venture-backed MBOs and MBIs are contributing significantly to Europe's corporate restructuring effort and helping to create new entrepreneurial businesses

?? In the UK, the private equity fund's long-term performance outperformed most of the principal stock market indices over three, five and ten years, including FTSE All-Share and FTSE 100. It yielded a 13% return over 3 years, a 15.7% return over 5 years and 17.4% return over 10 years respectively

?? Private equity investors are active partners providing more than finance. According to managers of investee companies, the three main contributions made by venture capital investors, other than finance, were financial advice, assistance on corporate strategy and acting as a sounding board for ideas.

?? Private equity backed management buy-outs led to greater competitiveness, increased employment and better pay.

?? 81% of managers of investee companies believed that their company would not have existed or would have grown less rapidly without venture capital.

Since the opening of former communist countries in the early 90, these countries have experienced a lot of interest of all foreign direct investment (FDI), investments via private equity and venture capital funds.

The last years have shown that investments in the technology sector have almost levelled to western standards, both in pricing as well as quality of the ventures. It seems, the CEE region jumped over some market stages by adopting the lessons learned from the western neighbours.

We feel that the difference between the new economy in the CEE region and its western counterparts became almost negligible and is more driven by stock prices and peer group evaluation than anything else. Venture capital does a lot for the CEE region in respect to growth, but the impact of venture capital does not differ from its influence in western hemispheres.

The same is only partially true for the old economy, where evaluation patterns differ substantially from comparable companies in the west. It is obviously far easier for new and emerging ventures to mimic the recent trends in the west than for bricks and mortar businesses to change the actual patterns.

Introduction

Over the course of the last four years, making the case for investing in private equity in Central Europe has sometimes been difficult. Returns on local equity markets have been volatile and have often fallen short of expectations. Returns have also suffered from contagion effects from events in other emerging markets.

The fundamentals are now changing. The Central European states of the Czech Republic, Hungary and Poland are entering a period of rapid, sustained growth in GDP. Inflation is down sharply from the double-digit rates of only a few years ago. Future membership in the EU from 1st of May 2004 is already contributing to convergence in inflation and interest rates towards West European levels. Membership in NATO and OECD and the existence of strong, healthy democracies are sharply reducing country risk premiums, a development that is unique to Central Europe among emerging markets.

In addition, emerging market contagion effects are working in reverse. Most of Southeast Asia is experiencing strong economic growth again and GDP in Russia and Ukraine is finally rising. Although still sizeable, some of the economic instability that has characterised Russia and the other successor states of the former Soviet Union has diminished. Finally, the U.S. equity valuations have also adjusted to more realistic levels. For these reasons, Central Europe promises to provide some of the most attractive investment opportunities among emerging markets in the coming years.

This paper will make the case for investing in Central European equities, in particular, private equity. In the medium-term, this asset class is projected to outperform other classes not only in the region but also in comparison with other emerging markets. The paper will first assess prospects for strong GDP growth in the region and for the convergence of inflation and interest rates towards EU levels. It will then evaluate prospects for equity markets in the region and the impact of Private Equity investment on the region. It will conclude with a discussion of the advantages of making private equity investments in the region.

The paper will concentrate on the Central European states of Poland, Hungary and the Czech Republic, the leading countries in the transition process. While the analysis also applies to other countries in transition, in particular Slovakia, Slovenia and the Baltic states, because of the size of the three Central European economies and the importance of their equity markets, the focus is on these three countries.

Economic rationale behind CEE convergence

The CEE countries are undoubtedly going down the convergence way towards the European Union. The economies of the CEE countries have experienced so far one of their most dynamic period in history and will continue going through a period of great convergence towards their western counterparts. This is where the biggest excitement for private equity investors entering the region comes from, as the gap between the EU and CEE countries' economies is still significant, thus offering a reasonable upside as this gap narrows in the future.

The CEE economies have more or less gone through privatisation and restructuring and are now entering a period of rapid sustained growth. The Inflation is under control and with the gradual price liberalisation seen in the region there are no threats of turbulence. Steady decline in unemployment in the region is supported mainly by direct investments and “greenfield projects”. With the strong inflow of foreign investments into the region coupled with incomes from tourism sector, the mounting C/A deficit poses a manageable challenge to the national banks of Eastern European countries. The external (current account) convertibility in some CEE currencies have been restricted before, but the full convertibility of those has been arranged according to IMF regulations already, even though in some countries the internal convertibility remains limited for local citizens. Some of the CEE currencies remain pegged (those of the Baltic countries) and some are freely convertible (CZK, SKK, HUF). But most of the currencies in the CEE should experience a stable period over the course of the next few years, before converting to the Euro. Thus, the region is marked as relatively safe in terms of FX risk for foreign investors in general.

All the macroeconomic fundamentals create a sound environment for GDP growth and wealth creation – a solid base for all investors in general.

Table 1: CEE MACROECONOMIC FUNDAMENTALS + FORECASTS

Poland	1998	1999	2000	2001	2002	2003F
GDP growth [%, y-o-y]	4.8	4.1	4.0	1.1	1.6	3.0
Industrial Production [%, y-o-y]	3.5	4.0	6.7	0.5	1.5	3.8
Unemployment rate [%]	10.4	13.0	15.1	17.4	18.7	18.0
CPI-inflation, [%, year end]	8.6	9.8	8.5	3.6	3.4	3.9
C/A deficit [% GDP]	-4.3	-7.6	-6.2	-4.0	-4.5	-4.3
Budget Balance [% GDP]	-2.7	-3.5	-2.2	-5.2	-4.9	-4.4

Source: WdB London

Hungary	1998	1999	2000	2001	2002	2003F
GDP growth [%, y-o-y]	5.1	4.2	5.2	3.8	3.6	4.0
Industrial Production [%, y-o-y]	11.8	9.7	18.7	5.0	4.6	5.8
Unemployment rate [%]	9.1	9.6	9.0	9.0	8.3	8.0
CPI-inflation, [%, year end]	10.3	11.2	10.1	6.8	5.5	5.0
C/A deficit [% GDP]	-4.7	-4.3	-2.9	-2.2	-2.8	-3.3
Budget Balance [% GDP]	-6.8	-3.8	-3.5	-3.4	-4.0	-3.5

Source: WdB London

Czech Republic	1998	1999	2000	2001	2002	2003F
GDP growth [%, y-o-y]	-2.3	-0.2	2.9	3.3	3.0	3.8
Industrial Production [%, y-o-y]	3.0	-2.0	5.1	6.8	4.0	5.0
Unemployment rate [%]	7.5	9.4	8.8	8.9	8.5	8.0
CPI-inflation, [%, year end]	6.8	2.5	4.0	4.1	3.5	3.3
C/A deficit [% GDP]	-1.9	-2.9	-4.5	-4.4	-4.5	-5.0
Budget Balance [% GDP]	-1.8	-1.6	-3.2	-2.8	-4.0	-3.8

Source: WdB London

Equity valuation assumptions and characteristics

The private equity market worldwide has experienced a strong growth (in funds) during last 10 years with the cumulative average growth rate at almost 40%. Demand for these instruments has been driven mainly by a history of superior private equity returns and distributions. A number of new institutions opening private equity/venture capital funds has been steadily increasing, building a broader portfolio of financial products. Pension and other long-term funds have increased their percentage allocations in the private equity funds, viewing them as a mean of deploying excess capital. As such, private equity investments have gradually started appearing on the radar screen of investors from Western Europe too. Investors seem to intend to reduce the number of managerial levels, having their investment managers tightened closer to the actual investments.

In the CEE region, we could have clearly seen a sectoral approach to private equity investment. While most of the investors rushed to invest to the "fancy" technology area across the borders, other areas remained virtually untouched as of yet. This obviously caused huge differences in the equity valuations across the sectors in the CEE markets. Especially in the area of internet and technology investments, similar valuations could have been seen as those in the US and Western Europe. The valuations in the technology sector have first gone through the roof and since early 1999 started declining. With the US equity valuation declining to more realistic levels, funds investing in the CEE region start broadening their investment horizon and start looking on other sectors too. The rationale behind is that technology and telecommunication sectors no longer provide such rosy upside potentials in terms of the old "sky-high" valuations. However, the US and Western European equity valuations remain the basic assumptions for valuations of the respective sectors in the CEE countries. The threat of long-term economic recession in the western universe would obviously affect not only the CEE economies and their growth, but also their respective equity valuations.

CEE private equity/venture capital markets

Overall, the private equity market in general (not only in the CEE region) is characterised by lower level of transparency and higher information imbalance than other parts of the capital markets. The non-existence of standardised investment tools and secondary markets creates a potential liquidity problem, should the private equity investor wish to exit the investment prematurely. It also burdens the information base that is generally available on private equity deals to outsiders. The private equity/venture capital market in contrast to the capital market is not regulated by an official body. This virtually removes any possibility for market supervision, performance presentation and disclosure standards. As most of the private equity/venture capital deals are intended to last for a period of several years, with no secondary markets available, questions can be raised on how to value the private equity portfolio before an actual exit is achieved.

A typical private equity fund investing in the CEE region is looking for the IRR of approximately 25-30% pa, which implies slight risk premium of roughly 5-10% for the location of the investment in the Emerging Markets area. However, the actual level of risk the Venture Capital investors are willing to undergo varies across the types of Venture Capital investments. The Internal Rate of Return is subsequently a derived function of the risk associated with higher return required for riskier investments.

The most risk-averse funds are those with mainly governmental sources of funds. They usually focus on handful of non-cyclical sectors like consumer goods, telecommunication etc. Such Venture Capital funds tend to invest for 3-5 years horizon and generally require 20-30%pa Internal Rate of Return on investments. Their main investment patterns are straightforward deals, providing development capital.

Private investors (including pension funds) in contrast to that are more risk-prone and thus are more flexible to search for less rigid-structured investments, including bridge financing, mezzanine financing, pre-IPO investments, distress situations, mergers and take-over investments, management buy-outs and buy-ins and special situations investments. Investment period can also vary from 1 year (in case of pre-IPO, mezzanine and bridge financing) to as much as 5-8 years (in special situations and management buy-outs). As these investments carry much greater risk, the required Internal Rate of Return on investments is in the range of 25%-40%pa. The more complicated transactions often include special risk-reducing features, enhancing the safety cushion for Venture Capital investor. To mention a few:

?? downside risk protection – turning the investment into a convertible bond effectively

?? earn-out / drag-along and tag-along clauses – giving the investor the right to exercise additional control if company targets are no achieved, including the right to initiate or participate in an eventual trade sale process

The highest demand amongst the Private Equity investors investing in CEE has traditionally been for investments in the information technology, telecommunication, internet, chemical, service and manufacturing industries in this respective order. As mentioned above, the focus is expected to shift slightly towards the "old economy" sectors for the reason of global equity valuation change. Several segments, for example military and tobacco industries have always remained outside the radar screen of private equity investors and this is projected not to change, as the main investors (mainly multinational non-private organisations) should hardly change their investment mandate in the "social" respect.

In the case of MBOs and MBIs financed by the private equity investor a strict management commitment is obviously sought. The empirical evidence shows that such management team had all co-invest their 1-year income in the initial phase. In later stages, even higher participation has been quite common.

Average intended investment period sought by private equity investors in the CEE has been 6 years with the range of 3-8 years, very seldom more or less. It is worth to mention that so far very little (almost none) private equity investments have reached their intended maturity in the CEE region. Nevertheless, some investments have been exited by trade sales to strategic investors, but most of them prematurely. Crucial point, thus for every private equity investor is the mean of exiting the investment.

The process of private equity investing in the CEE countries requires perhaps even deeper attention, as several of the investment patterns not necessarily automatically work in the region, compared to the situation in Western Europe and the USA. There are certain specifics in the private equity Investment Cycle (Fig. 1) typical in the CEE region:

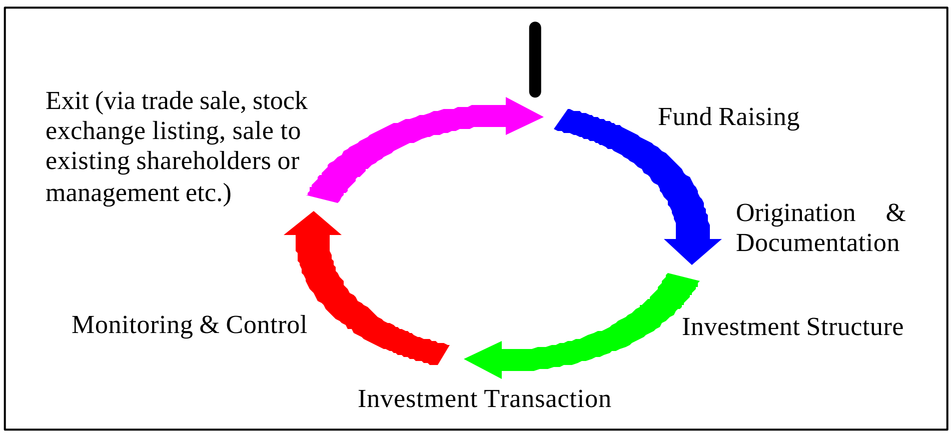


FIG. 1: PRIVATE EQUITY INVESTMENT CYCLE

?? Fund Raising – predominant investors in private equity/venture capital funds investing in the CEE region are governmental organisations and multinational non-private banks (EBRD, EIB, World Bank etc.) unlike in the USA and the UK, where the main contributors are companies from private sector like banks, pension funds and insurance companies accompanied by private individuals.

?? Origination & Documentation – as a result of smaller potential market size in the CEE countries, some burdens are placed on private equity funds investment managers in terms of the size and structure of potential deals, as there usually is only a limited number of potential sizeable deals. The potential deal-size is a hurdle, as an average private equity fund operating in the CEE region is looking for single investment of approximately $10m and it may be sometimes difficult to find suitable investment opportunity, compared to more mature and larger Western European and US markets. The lower level of corporate governance also makes it rare situation for a small and medium developing company to have an acceptable financial audit from a reputable international company (the so called big 5). As private equity funds can hardly make any investment without a thorough due diligence on the target company, the non-existence of the basic reliable financial audit poses a serious complication from time and financial point of view.

?? Investment Structure – this is where there are almost no differences in comparing private equity investments in the CEE region and their western peers.

?? Investment Transaction – itself also contains only minor differences to the process in Western Europe and the USA.

?? Monitoring & Control – requires perhaps the biggest personal involvement of the investment managers of the private equity/venture capital funds. Since the corporate governance and business culture usually do not reach the levels seen in western countries, some of the highest valued contributions of private equity investors are the new financial and business advice and the creation of corporate strategy. Nevertheless, the private equity investor's role has mainly been limited to the supervisory board membership in the investee company.

?? Exit – with very weak local equity capital markets in the CEE, the main hope for the investors must have been company trade sales to a strategic partner or some version of management buyout. Potential capital market listing has to be approached cautiously and with the view to list the investee company in the broader pan-European capital markets platform should this be suitable (LSE Alternative Investment Market etc.). Strategic investors trade sales are therefore more appropriate and enable to search for the investor on world-wide reach basis.

Among the private equity/venture capital companies investing in the CEE region, the main players are: Advent International, GE Capital, Warburg Pincus, Dresdner Kleinwort Capital, Barings Private Equity, Doughty Hanson, Emerging Market Partnership, AIG, RZB Private Equity, Bancroft UK, Renaissance Partners, EPIC, CSFB Private Equity, CVC Partners etc.

As the impact of private equity investments on the CEE region is concerned, the following table (Fig. 2) is self-explanatory. The main impacts are depicted on the level they most closely affect.

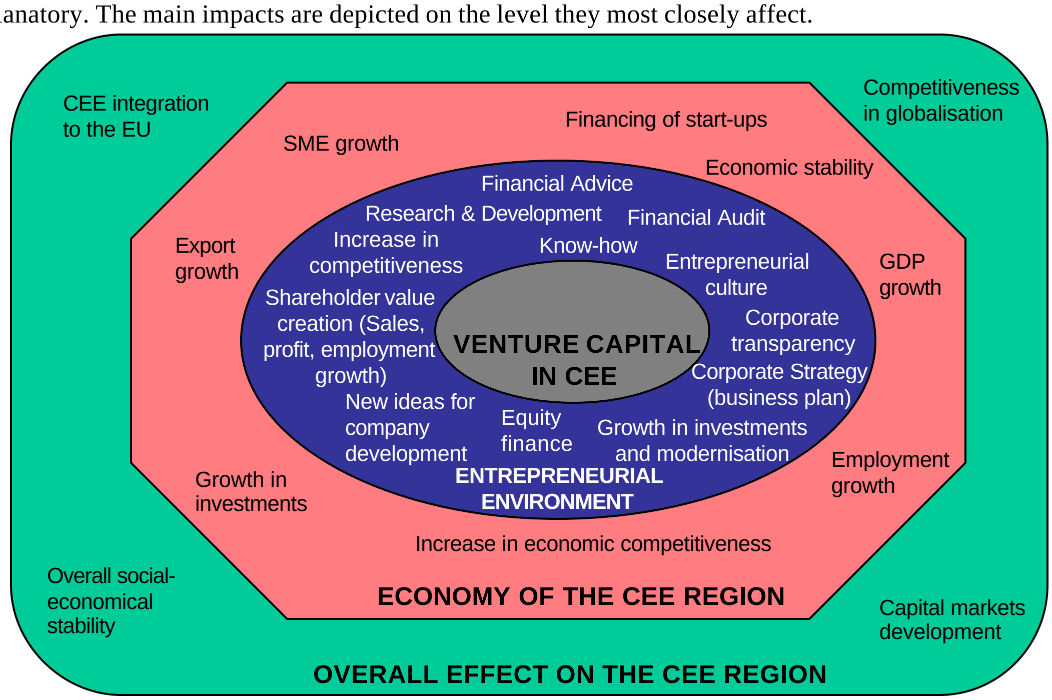
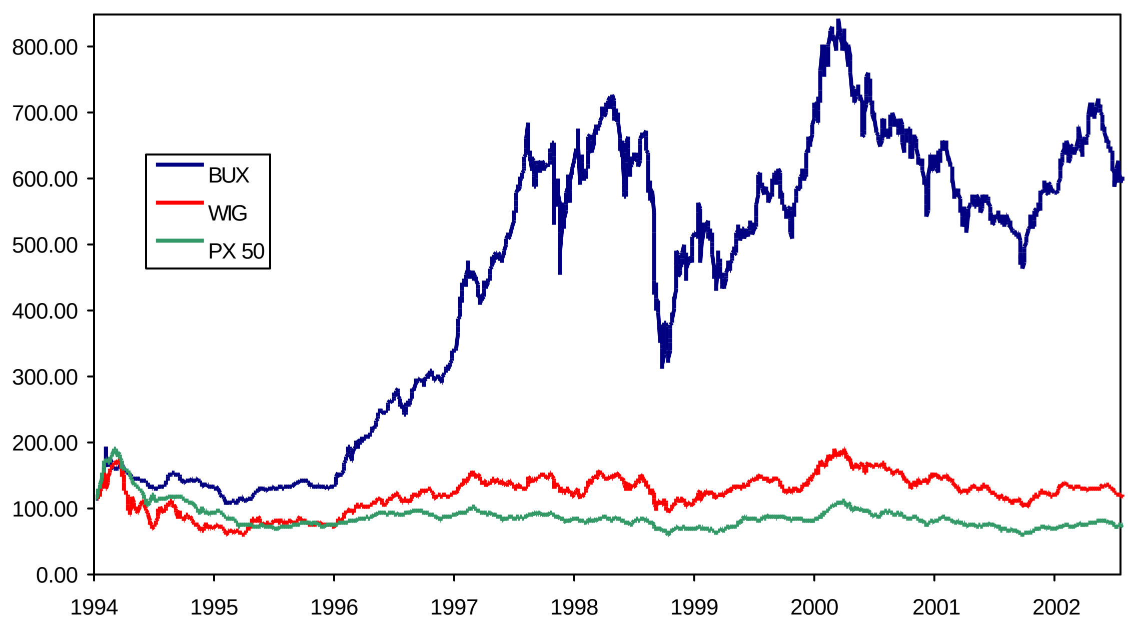


FIG. 2: THE IMPACT OF VENTURE CAPITAL/ PRIVATE EQUITY ON THE CEE REGION

EU/CEE equity markets outlook, impact on CEE private equity

In early 1991 in Hungary, 1992 in Poland and 1994 in the Czech Republic, equity capital markets were born. Many investors rushed into the CEE region to take advantage of new, fast developing markets, which offered attractive investment opportunities in terms of very low asset valuations. Major US and European Asset Management firms contested to open dedicated CEE equity funds to attract investors. In the early stages all the CEE capital markets performed really well and most of the investors booked hefty gains in their portfolios. However, the lack of corporate governance, slow structural reforms and huge political influence over the transforming Eastern European economies caused that many of the investors "burned their fingers". The devastating effect had a special magnitude in the smaller markets (for example: foreign investment restrictions imposed in Slovenia, privatisation scandals in Slovakia etc.) or during the Russian crisis in 1998.

Looking back at the equity markets performance in major CEE countries (Fig. 3) implies that of the three main capital markets, only that of Hungary actually produced any sensible return. This implies that the typical USD-benchmarked foreign portfolio investor investing into CEE equities would be hardly posting any sensible returns on the portfolio, but perhaps breaking even in the best case.



Source: Reuters

Fig. 3: CEE EQUITY MARKETS PERFORMANCE [RE-BASED AS OF 3/JAN/1994 TO 100 POINTS]

Originally it seemed to be a brilliant idea to exit venture capital investments via equity capital markets, as most of the CEE markets did well. Unfortunately, because of the later performance the importance of the local equity capital markets has been declining. As a response to the weakening CEE markets during the last 2-3 years, some of the companies from the CEE region (mainly the early stage ones) sought listings and IPOs directly on the Western European and US bourses. Examples of that include Hungarian Graphisoft (Neuer Markt), Polish Netia (NASDAQ, LSE), Russian MTS (NYSE) and Golden Telecom (NASDAQ) etc. The recent consolidation and merger activities of western stock exchanges seem to indicate that in the future there will be a pan-European platform with special segments for trading respective industry sector based shares. As with many other things in life – size does matter – and the smaller markets (especially those of the CEE) will face a difficult challenge to survive. And with diminishing number of instruments – shares to trade – with prevailing lack of new issues and finishing privatisation activities, their independent survival might prove a major hurdle. At the end of the day the CEE stock exchanges will have to give up and integrate into broader pan-European market structure, enabling investors to enter all the European markets at once.

Important factor worth mentioning is the planned pension reform in the CEE countries and emergence of local pension fund investors base that these reforms will create. Poland has pioneered this field in the last years and with its pension reform created local investors base with assets well over $12bn as of 2003. Of this amount, nearly $2.5bn was invested in local equities, helping the Polish bourse to perform better. In future, the newly created pension funds could prove a vital driver for local stock exchanges, helping create a platform enabling private equity investors exit their investments.

Outlook for private equity investments into CEE markets

The outlook for private equity/venture capital investments in the CEE region has to be considered in the light of:

?? The European integration process – as the CEE countries converge towards the EU, not only their political systems will equalize with the EU standards, but also their economies will grow to match the levels of their western counterparts. With ill-functional or almost non-functional (in some countries) equity capital markets, one of the best opportunities for investors to bet on this convergence play seems to be the private equity business.

?? Increased financial valuations in the CEE – in certain sectors (such as the new economy), asset valuations in the CEE have already levelled out to the western rank. Nevertheless, a big gap in asset valuation remains in the field of old economy. This disparity has been caused partly by sky-high valuations in the new economy sector, partly by the difficulty to restructure the old economy to adapt to market practices and be competitive. It is this valuation gap that creates the upside potential for investors to profit on supplies of finance for the growth.

?? Globalisation and ownership centralization – as in the other parts of the world, also in the CEE, huge interest from (mainly foreign) strategic investors can be seen to take over the smaller CEE peers and to integrate them. The strong strategic investor can not only help restructure the target company, but also create savings from the economies of scale and finally, the target company profits from being a part of large conglomerate. This process started in the CEE already in early 90s, since the privatisation program began. Gradually we are witnessing a shift more towards the corporate sphere, where domestic and foreign companies integrate local CEE companies in order to maximize the synergy effects (e.g. Hungarian MOL and Slovakian Slovnaft). Private equity investors can view these globalisation and integration trends as a favourable way to exit their investment.

Private equity investment in the CEE offers opportunity whereby investors could both take advantage of very low asset valuation and look forward to rapidly developing economies. Private equity investments enable investors to more directly interact with the investee company, supervise their investments and avoid any potential problems with weak corporate governance or entrepreneurial culture, such as portfolio investors often have to face in the CEE region. Thus, private equity seems to be the best proxy to the economic growth potential of the region while maintaining certain investment protection degree. This asset class definitely seems to be poised for take-off in the CEE region. Have you got your seatbelts fastened?

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Contact the Author for a list of References.

Europe's ETF Market: Emerging Trend or Imminent Shake Out?

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Abstract

With over 100 product offerings in just over three years, the exchange-traded funds (ETF) market in Europe has grown remarkably in recent years. The rise of ETFs coincides with increased investor interest in (relatively cheaper) passive investing. However, doubts remain as to its potential to match the U.S. in terms of assets under management anytime soon. The European market is persistently fragmented due to multiple regulatory agencies and taxing authorities, numerous products on the same underlying benchmark, and the existence of many subscale exchanges.

Introduction

With the arrival of ETFs in Europe in April 2000, a whole new panorama of investment opportunities was opened up for both private and institutional investors. Their phenomenal growth since their introduction confirms that they are indubitably gathering momentum. So, what makes them so unique that the gap between the number of US and European ETFs has been closed in a matter of just over three years?

Demand from investors facing the dynamics of an ever-changing market has certainly been the engine behind their development and as this demand increases more esoteric ETFs are launched. But before analyzing their growth in Europe, we must first examine the environment in relation to that in the US where these investment vehicles are seemingly thriving. This could shed some light on whether European ETFs are capable of bridging the gap with their US counterparts in terms of assets under management (AUM.) as well.

Indeed, in the face of the ongoing inconsistency of the financial markets and persistent fragmentation of the regulatory markets, several experts have doubted their ability to truly match the success they have experienced in the US. These experts are, nevertheless, well aware that in addition to their phenomenal proliferation, European ETFs reached in just over two years, the same AUM level that it took the US over four years to reach.

The Two Markets Have Common Features But Also Quite A Few Differences

In a broad comparison of the US and European ETF markets, one might start by saying that the most popular ETFs in both continents have more or less the following common features: liquidity, low costs, full index replication, transparency, and simplicity. In themselves, these commonalities should logically ensure to European ETFs a degree of success similar to the one experienced in the US.

It is generally agreed that the single most important ETF characteristic is liquidity. With live prices on the exchanges and the ability to continually make bid and offer prices, dealers help generate the narrow spreads and sizes that yield a liquid product. Although an ETF's net asset value (NAV) can theoretically be different from the exchange price, arbitrage opportunities during the trading process keep both premiums and discounts at a minimum.

Spreads are also kept narrow thanks to the products' transparency. Investors know exactly what the fund is holding, which helps generate an indicative NAV at any moment in time. This allows for a continual comparison between the ETF quoted price and its so-called fair value. As to replication, in spite of all the talk regarding European integration, ETFs that fully replicate individual country indices are still among the most actively traded. In comparison, the most actively traded ETF in the US, but no means the largest, is the QQQ, which tracks the Nasdaq-100, an index that includes some of the biggest information technology companies with household names such as Microsoft, Cisco, and Dell.

Finally, one of the main benefits of ETFs is that they have cheaper management fees, compared to other investment alternatives. From this perspective, however, ETF expense ratios in Europe remain much higher than those of their counterparts in the US. For example, at the time of their launch, the Stoxx 50 LDRS (EUNF) and the FTSE 100 (ISF) products, both underlined by core benchmarks, had expense ratios of 0.35% and 0.50%, respectively, compared to only 0.12% for the Standard & Poor's 500 Depositary Receipts (SPDR) or 0.09% for the iShares S&P 500 (IVV). To their credit, total expense ratios have been gradually declining in Europe since their introduction in March 2000.

Europe's Regulatory Markets Are Still Fragmented

In spite of the many common features European offered ETFs have with US ETFs, doubts remain as to their ability to mirror US ETFs' success. Critics believe that it is one thing to rival the US in terms of the number of traded ETFs but quite another to match its success in terms of AUM. For now, total ETF assets in Europe are only a sliver of that in the US. Many reasons are being advanced as to why the two figures will not be the same any time soon including competition from the futures market and market fragmentation.

European investors are generally considered more comfortable with futures than their American counterparts. For example, it is only recently that the ban on trading single stock futures has been lifted in the US. Regulators justified the ban arguing that, just as individual securities are open to manipulation, derivatives constructed around them could also be manipulated to influence the price of the underlying stock. Given that several successful liquid futures already exist on many of the popular indices tracked by European ETFs, experts have doubted the mass appeal of these funds in Europe. Not only are European investors more familiar with futures, but also many believe that the latter carry lower transaction costs than ETFs.[i] Of course, just as in the US, increased competition could push costs significantly lower once the market has reached sufficient depth. This is not to say that buying futures is easier in Europe. Just as in the US, one has to have an established relationship with a broker as well as considerable financial resources since, contrary to ETFs, futures cannot be bought in small denominations.

Market fragmentation is another argument advanced against the success of European ETFs matching that of US ETFs. For all the talk of a united Europe, doubters point at the eurozone as still a collection of individual countries. They rightly claim that its still uncoordinated regulatory framework as shown by the existence of multiple regulatory agencies and taxing authorities keep the marketplace very fragmented. For example, considering that the widely accepted tax efficiency of ETFs has been instrumental to its growth in the US, they can hardly imagine a parallel success in an environment where unsynchronized tax regimes could turn the marketplace into a minefield for the unsuspecting investor.

Furthermore, Europe still has multiple regulatory agencies. Ceteris paribus, every individual regulatory authority must be approached separately because each has different concerns and issues that affect the product and its marketing, distribution, and trading, not to mention registration that must be enacted in different languages. For example, in Spain, deemed by ETF providers as the most difficult country along with Italy, the country's financial-services regulatory agency requires the use of government-approved translators, contrary to Sweden where the documents don't have to be translated from English. ETF approval can also take a longer time in Spain, especially if the application form isn't filed correctly.

Last but not the least**,** multiple clearing and settlement systems along with multiple product listings add extra layers of difficulties to the viability of ETFs. In the US, on the other hand, a single regulator, the SEC, controls all ETFs. They also trade mostly on one exchange, the American Stock Exchange (Amex), and in one single currency.

The European Commission, the eurozone's executive arm that is supposed to enforce single-market rules, admits that it has been slow to fix the problems. Its efforts to create a single market for financial services across the 15-nation European Union (EU) have been understandably hampered by a multitude of barriers, including dealing with a separate regulator in each country and 11 official languages.

Europe's ETF Market Is Experiencing An Explosion Of New Products

In Europe, ETFs are a relatively new industry, with the first product launched just over three years ago. Despite falling stock markets and fears that this might deter Europeans from investing, ETFs have proliferated to such an extent that Europe now has more listed ETFs than the US (122 versus 114 as of June 2003) where the first product was launched on the Amex in 1993. Table 1 illustrates the development of listed ETF offering in both areas since April 2000, with the launch by Barclays Global Investors of their iShares products in the US and Merrill Lynch of their Listed Diversified Returns Securities (LDRS) in Europe.

Table 1: LISTED ETF GROWTH: USA VERSUS EUROPE

	Assets in $US (Billions)		Number of Funds	
Date	USA	Europe	USA	Europe
Apr-00	$38.12	$0.43	30	3
Jun-00	$46.15	$0.50	56	3
Sep-00	$49.70	$0.51	76	3
Dec-00	$65.59	$0.68	80	6
Mar-01	$66.00	$1.84	83	16
Jun-01	$75.56	$2.63	85	33
Sep-01	$64.35	$3.54	92	43
Mar-02	$88.20	$6.90	102	92
Jun-02	$88.95	$8.50	102	92
Sep-02	$82.26	$7.70	106	111
Dec-02	$102.14	$10.69	113	118
Mar-03	$102.28	$11.86	114	116
Jun-03	$121.20	$15.78	114	122

Source: Morgan Stanley, Investment Company Institute, Bloomberg, and SSGA.
As of June 30, 2003.

The total assets under management for European ETFs stand at $15.78 billion (13.52 billion euros at 1.1674 US dollar to the euro) as of June 2003. This represents approximately 13% of the US market. The US therefore clearly remains the leading market for ETFs even if Europe has made huge strides illustrated by a significant growth of about 86 percent over the June 2002 figure and a remarkable 232 percent since April 2000. Also worth noting is the fact that European ETFs have reached the $10.7 billion mark in just over two years, the same level that it took the US over four years to reach.

It Is Also Experiencing A Proliferation Of ETF Managers

Europe's ETF market is quite open as shown in Table 2. It leads the rest of the world with 14 managers, followed by the US with 7 managers, then Japan and Korea with 4 managers each. In the US the ETF market remains dominated by a few players such as Barclays Global Investors (BGI), State Street Global Advisors (SSGA), and the Bank of New York (BONY). Europe's three main issuers share around 58% of the market compared to a much higher percentage for the aforementioned US managers. With 24 percent market share and 32 ETFs listed on the Deutsche Borse, IndEXchange is now the largest manager of ETFs in Europe. Set up by HypoVereins Bank, it is based and distributes mainly in Germany. This is quite a change from 2000, when US-based companies such as BGI and Merrill Lynch had the market for themselves. With 15.3 percent and 13.7 percent, respectively, these two companies have slipped to third and fourth in terms of market share, behind the surging Lyxor. Lyxor is the asset management subsidiary of Societé Generale, another European-based ETF provider. Relatively speaking, it is a brand new player, which has hit the ground running with the Master Share CAC 40 (CAC FP). Targeting the institutional market, Lyxor quickly grabbed 18.8% of the market, which translates into $US2.98 billion in managed assets. Although a dominant player in the US ETF market, SSGA ranks only sixth in Europe with 6.8% market share. To its credit, however, SSGA joined the crowd with its streetTracks sector funds much later than the two aforementioned American companies. The dominance of banks on the European ETF market underscores another major difference between it and the US market. Usually, this is a function of better distribution channels. Because they seem to benefit from the trust of European private investors who are more accustomed to dealing with banks than with money managers, they can effectively use their existing channels to educate and facilitate the acceptance of ETFs by the general public. In the US, on the other hand, money managers predominantly run the ETF market. Here, the focus is on brand recognition of not only the sponsoring institution but more importantly the underlying index. As a case in point, SSGA is the manager of the SPDR which is based on the S&P 500 and is the largest ETF in the world; despite this, the SSGA streetTracks ETFs, based on lesser known Dow Jones indexes have gathered very few assets and some were even discontinued.

Table 2: MANAGERS OF EUROPEAN LISTED ETFs

Managers	Number of ETF Li	Assets	Market
stings	(Billions)	Share (%)	
AXA Gestion	12	0.39	2.5
BGI	15	2.42	15.3
Credit Lyonnais	2	0.51	3.2
Credit Suisse	5	1.59	10.0
IndEXchange AG	32	3.80	24.0
Merrill Lynch LDRs	15	2.33	14.7
Societe Generale (Lyxor)	5	2.98	18.8
SSGA	15	1.08	6.8
UBS Asset Management	11	0.48	3.0
Others	5	0.29	1.8
Total	117	15.80	100.0

Source: SSGA ETF Research. As of August 13, 2003.

Europe Has Many ETF Exchanges

Unlike the US, which still has one dominant exchange for the listing of ETFs (the Amex), Europe has several exchanges competing for ETF activity (see Table 3). Whether there are too many exchanges or just enough to keep the competition healthy is, of course, a matter of opinion.

Despite the existence of UCITS rules established to facilitate the marketing and distribution of ETFs in Europe, a still fragmented marketplace has forced issuers in Europe to go through the time and expense of obtaining multiple listings on these exchanges. However, even as European investors seek to diversify their ETF holdings, they still buy the funds primarily on the Deutsche Borse, the first exchange to list ETFs in 2000.

Table 3: ETF TRADING VOLUME IN EUROPE

Exchange	Average Daily USD Volume	Share Daily Volume (%)
Berlin Stock Exchange	$19,501	0.0%
Borsa Italiana	$6,4343,306	2.0%
Deutsche Borse	$140,751,718	44.2%
Euronext	$70,573,466	22.2%
London Stock Exchange	$59,079,960	18.6%
Swedish Stock Exchange	$17,335,661	5.4%
Swiss Stock Exchange	$20,791,629	6.5%
Virt-x	$3,140,413	1.0%
Total	$318,330,227	100.0%

Source: Morgan Stanley. As of June 30, 2003

According to data obtained from Morgan Stanley, the Deutsche Borse garnered nearly 44% of the volume of Europe's ETF business. Euronext, the only pan-European exchange follows with 22.2% of the trading volume.[ii] With 57 and 56 ETF listings, respectively, these two exchanges are considered the most assertive and successful of the group and have emerged as the main centers of ETF activity in Europe. With far fewer listings (16) but 18.6% of the trading volume, the London Stock Exchange is not far behind Euronext. Virt-x, one of the smallest of these exchanges, is known as the pan European blue chip electronic exchange. Until the beginning of 2003, Virt-x was jointly owned by a consortium of ten banks and the SWX Swiss Exchange. SWX has since bought out the banks and now owns about 95% of the equity capital and voting rights of Virt-x. According to the exchange's web site (www.swx.com), SWX is the only exchange that offers ETFs in multiple currencies.

Certainly there are subscale exchanges in Europe that would not have survived in a more homogeneous setting such as the one characterizing the US financial markets. Because fragmentation seldom generates market efficiency, these markets are not expected to disappear as long as the former persists. Also, fragmentation has made it hardly possible to find one source where all ETF data is deposited on a timely and regular fashion. As a result, information important to investors such as closing prices is sometimes hard to find.[iii]

Asset Allocation In Europe's ETF Markets

The flexibility and lower expense ratios of ETFs when compared to other financial products has fueled their growth in Europe just as it has in the US and elsewhere. Compared to their underlying securities, they provide a level of diversification that would otherwise be time consuming and expensive. They also provide a more efficient investment alternative for settlement and administrative purposes.

Table 4: ETF BY INDEX CATEGORY

	Market Share (%)	AUM ($US)	Market Share (%)
Eurozone	32%	$4,834,110,212	31%
Regional Europe	12%	$1,551,703,802	10%
Eurozone Sectors	2%	$529,168,740	3%
Europe Sectors	6%	$689,020,480	4%
Global Sectors	2%	$155,018,991	1%
European Country Benchmarks	38%	$5,948,387,739	38%
International	8%	$1,844,444,306	12%
Fixed Income	0%	$206,069,950	1%
Total	100%	$15,757,924,220	100%

Source: Numbers compiled from Morgan Stanley Equity Research Europe Data

In setting their investment objectives, European investors seem to consider their fragmented markets as temporary. Indeed, in spite of the continuing volatility of the financial markets, on most measures Europeans seem to have more or less maintained the level of their investments in European-listed ETFs.

Beyond issuer or exchange differences, it is telling to look at ETF growth broken down by investment coverage. In table 4, ETF AUM is divided into eight distinct investment categories reflecting the dynamics underlying Europe's current business environment. The difference between regional Europe and the eurozone is that the constituents in the latter comprise only those countries in the EU that have joined the euro, whereas the former can be made up of ETFs from any country located in Europe regardless of its monetary denomination.[iv] Country benchmarks are based on established local indices such as the CAC 40 in France, Germany's DAX or England's FTSE 100.

Country indices are the most familiar indices to European investors and have a long history as the basis for investment. Unsurprisingly, with 38% of ETF AUM (a portion that remains little changed since December 2002) country-based ETFs still command most of European investors' attention. This is followed by regional ETFs such as those tracking the eurozone (31%) and regional Europe (10%).

As to sector investing, in theory it should appeal to investors who seek the performance potential that individual stocks in a sector may offer but do not want to take the responsibility of researching individual companies. It should also attract investors who want to target a strategic opportunity and believe that a particular sector is about to enter a period of strong performance.

In practice, however, sector investing does not seem to have picked up in Europe, in spite of allegations to the contrary from the financial press.[v] According to Morgan Stanley's data (see table 4), the market share of both global and Europe's sectors decreased over a sixth-month period starting December 2002, whereas that of the eurozone sectors increased a modest 1%. This trend or lack of may explain recent announcements by Merrill Lynch, BGI, and UBS to discontinue a total of 26 sector ETFs in Europe.

Clearly, there is a lack of interest in sector investing on the part of European investors in spite of its theoretical groundings. In an effort to explain it, one might suggest that they have perhaps come to realize that the establishment of a single European market is not a simple matter after all and will take sometime to implement. As to the ETF providers, some of the main players may have decided that these products are too costly to maintain given their low asset base although launching these sector ETFs seemed logical given Europe's move toward integration. Perhaps, they have realized that they have simultaneously jumped into a still shallow market creating a crowding out effect. Whether this is a shakeout from which fewer but more economically viable products will emerge remains to be seen.

Conclusion

While the European market for ETFs has developed significantly on most measures over the past few years, certain changes to the environment in which these investment vehicles continue to operate remain necessary for sustained growth. These changes should lead to a true pan-European single market that eliminates the need for individual country registration. By facilitating ETF access to both institutional and retail investors and significantly lowering their costs, such a market would allow the ETF trend in Europe to truly mirror that of the US.

In the meantime, ETF exchanges, such as Euronext, which provide a single point of entry for issuers instead of approaching each country's regulatory authority separately for permission to be listed, might be a partial answer to the regulatory challenges still beleaguering Europe's ETF market.[vi] Under the Euronext market format, trading fees become uniform because the same electronic platform facilitates the listing, clearing processes, and the trading of the product. However, other serious issues such as taxes remain unresolved as they continue to depend on the investor's country of residence.

End notes

[i] Although many experts advise to carefully weigh up the difference in costs. For example, Massoud Mussavian, director of equity derivatives and Jacques Hirsh, equity derivatives analysts, both at Goldman Sachs, advise investors to carefully assess the initial costs and holding costs associated with the two investment alternatives. For more detail, see M. Mussavian and J. Hirsh in "Counting the Costs: ETFs versus Futures," *Financial Times Mandate* (June 3, 2002).

[ii] Euronext was created in September 2000 by the merger of the Paris, Amsterdam, and Brussels exchanges.

[iii] For detail, see "A Future Replacement," the theme of a round table organized by *Global Pensions* (July, 2002).

[iv] The member countries are Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. Collectively these countries are known by their official name of the 'euro area' or more formally the 'eurozone'. Denmark, Sweden, and the United Kingdom are the three remaining members of the EU who have yet to join. Note that Sweden overwhelmingly rejected the euro in a recent vote.

[v] For example, see "European and Global Sector Products," the theme of a round table in the *Financial News*, December 17, 2001 or more recently, an article by Eelco Ubbels "Stock Picking is Old Economy: Sector Picking Will be the Future," in *International Fund Management*, March-April, 2003.

[vi] Currently, issuers gain access to trade on the three exchanges comprising Euronext simply by choosing one as their home market and jurisdiction. This means that they are subject to only one regulatory authority, that of the country in which they are granted permission to list.

Test of Weak Form Market Efficiency: Evidence from Dhaka Stock Exchange

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Abstract

The Dhaka Stock Market appears to be weak-form efficient. Stock prices have a unit root. Predictability of returns arising from auto correlated errors is also ruled out by variance ratio tests. Although a heteroscedasticity-robust Box-Pierce test was used by Lo and MacKinlay (1989) in their Monte Carlo experiments, our study appears to be the first one to apply this test to stock prices. By this test, we have resolved the conflicting results reported by two recent studies of the Dhaka market. Autocorrelation tests typically reject weak-form market efficiency. Given our results, we suspect that previous findings, based on the usual autocorrelation tests, may be reversed by using a heteroscedasticity-robust test.

1. Introduction

The securities market is a crucial institution in the financial system of any country. The activities of buying and selling of shares on the securities market are extremely important for efficient allocation of capital through proper pricing of capital and risk. An active securities market contributes to economic growth by increasing the funds available to finance industries and other productive enterprises, and by channelling the funds into the appropriate industries and other productive activities. In a capital starved country like Bangladesh, efficient allocation of scarce resources and encouragement of foreign private investment are both of vital importance. Success of an increasing privatisation of the economy now under way in Bangladesh will depend crucially on the presence of an active share market. The role of stock markets in harnessing domestic saving takes on an extra dimension in a country like Bangladesh with a predominantly Muslim population. According to the Islamic faith, usury (*riba*) is prohibited. The correct interpretation of *riba* is a highly contested matter in Islamic economic discussions, but there are many Muslims who consider any fixed interest saving instruments as unacceptable. For such people, a well functioning stock market can provide an ideal alternative saving/investment mechanism. At present, there are two stock exchanges in Bangladesh, namely, the Dhaka Stock Exchange (henceforth DSE) and the Chittagong Stock Exchange (CSE).[1] For the purpose of this study we will concentrate on the DSE, as this is the country's oldest stock exchange, and according to Standard & Poor's "Emerging Stock Markets Fact book 2000", the DSE is one of the frontier emerging markets of South Asia.

Compared to the stock markets in developed countries, the emerging stock markets are in many cases characterised by a lower volume and frequency of trading ('thin trading'), ease of manipulation by a few large traders, weaker disclosure and accounting requirements, settlement delays, and a generally less than smooth transmission of financial information. If correct information on business performance and prospects fail to be quickly and fully reflected in the stock prices, those who are privy to such information can benefit by anticipating the course of such prices. Stock markets are said to be efficient when all available relevant information is reflected in the stock prices. Any abnormal price changes should not be predictable in an efficient market. When any random components in the changes of a share price are not correlated, unpredictability (or efficiency) of such a price is also known as a 'random walk'. Emerging stock markets may not be efficient in this sense owing to imperfections like those mentioned above. By failing to price capital and risk correctly, an inefficient stock market is not likely to be able to make its full possible contribution to economic development of a country.

A stock market is said to be inefficient in the weak form if stock prices and/or returns are predictable based on past information on them. The findings of market efficiency tests (mostly weak-form efficiency tests) on emerging markets are rather varied. Some researchers find evidence in favour of weak-form efficiency, as they cannot reject the hypothesis of a random walk in emerging markets (Chan, Gup and Pan, 1992; Dockery and Vergari, 1997; Ojah and Karemera, 1999; Alam, Hasan and Kadapakkam, 1999; Cheung and Coutts 2001; and

Abrosimova and Linowski, 2002). On the other hand, some researchers are able to reject the hypothesis of random walk, and therefore find evidence of predictability of stock prices in the emerging markets (Ko and Lee, 1991; Claessens, Dasgupta and Glen, 1993; Cheung, Wong and Ho, 1993; Urrutia, 1995; Poshakwale, 1996; Lee, Chen and Rui, 2001; Smith, Jefferies and Ryoo, 2002; and Mobarek and Keasey, 2002).

There have been only two studies so far (Alam, Hasan and Kadapakkam, 1999; and Mobarek and Keasey, 2002) testing the market efficiency of DSE. The results are conflicting. Applying a variance ratio test, Alam, Hasan and Kadapakkam found that the monthly stock price index series of the DSE (during 1986 to 1995) followed a random walk, which implies the existence of weak-form efficiency in the market. However, by applying runs and autocorrelation tests, Mobarek and Keasey concluded that the daily price index series of the DSE (for the period of 1988 to 1997) did not follow a random walk. In addition to the aggregate DSE index, Mobarek and Keasey also considered 30 randomly selected companies which had shares actively traded during their study period. Their results for these individual shares also suggested that the Dhaka Stock Market was not weak form efficient.

However, Mobarek and Keasey concluded that one should interpret their findings cautiously because of some limitations in their study, e.g. they used daily data, which may not allow a reliable test of stock market efficiency in a country like Bangladesh where thin or infrequent trading is a problem for some individual components of the share price index. Other limitations of their study are that, in their individual company tests, they used data that were not adjusted for dividend, bonus and rights issues; prices not adjusted for these factors might not reflect the real forces driving the market.

Besides making a contribution to the literature on the assessment of efficiency of an emerging stock market with more recent information, the aim of this paper is to revisit the Dhaka Stock Market data to determine if the conflicting results reported by the only two studies on this market to date stem from different test methods employed and/or from the use of monthly versus daily data. We carry out a more comprehensive study by considering data at all of the three intervals – daily, weekly and monthly. The DSE index and the individual indices for the top 95 companies listed on the DSE – those with market capitalisation above the median level – are examined for the period January 1990 to November 2001. The rest of our discussion begins by outlining the various methods typically employed in testing for stock market efficiency in section 2. A brief summary of results of such tests in developed and emerging stock markets are then presented in section 3. A short history of the DSE and description of data on the DSE share prices used in our tests are included in section 4; this is followed by a presentation and discussion of efficiency test results in section 5. Our conclusions are finally stated in section 6.

2. Methodology

Efficiency in financial markets is generally represented as lack of predictability of market returns in excess of normal returns. According to the weak form of the efficient market hypothesis (EMH), the current rate of return cannot be predicted by past rates of return. If P_t is a share price, rate of return $R_t = \ln P_t - \ln P_{t-1}$. Consider the multiple regression:

$$R_t = ?_0 + ?_1 R_{t-1} + ?_2 R_{t-2} + \ldots + ?_k R_{t-k} + ?_t \qquad (1)$$

Where $?_t$ is a random error. Here, the weak EMH is the hypothesis that H_0: $?_1=0, ?_2=0, \ldots, ?_k=0$. Under this hypothesis, $R_t = ?_0 + ?_t$, that is,

$$\ln P_t = ?_0 + \ln P_{t-1} + ?_t \qquad (2)$$

Which is known as a ‘random walk’ or a ‘unit root’ process. Thus, weak EMH can be tested in two alternative ways, either by testing H_0: $?_1=0, ?_2=0, \ldots, ?_k=0$ in (1), or by testing for a unit root in (2). An F-test could be used for the former if R_t satisfied stationarity, i.e. it didn’t have a unit root. An alternative to this test used by many investigators of the EMH is the Box-Pierce test of autocorrelations. Let correlation between R_t and R_{t-h} = $?_h$. Under weak EMH, $?_h = 0$ for any h. In this case, the statistic

$$Q = T\sum_{j=1}^{h} \hat{\rho}_j^2 \qquad (3)$$

Where T is the number of observations, is asymptotically distributed as chi-square with h degrees of freedom.[2]

Unit roots are usually tested by an augmented Dickey-Fuller (ADF) or a Phillips-Perron (PP) test, but a more commonly used test in financial economics is the variance ratio (VR) test developed by Lo and MacKinlay (1988). This test is based on the fact that the variance of the q^{th} difference of a random walk increases linearly with q. Let $\Delta \ln P_t = \ln P_t - \ln P_{t-1}$ be the first difference, and $\Delta_q \ln P_t = \ln P_t - \ln P_{t-q}$ be the qth difference. The variance ratio $[var(\Delta_q \ln P_t)]/[q(var(\Delta \ln P_t)]$ will equal 1 for a random walk process. Using this ratio, Lo and MacKinlay define another measure:

$$M(q) = [var(\Delta_q \ln P_t)]/[q(var(\Delta \ln P_t)] - 1 = \sum_{j=1}^{q-1} \frac{2(q-j)}{q} \hat{\rho}_j \qquad (4)$$

Where $\hat{\rho}_j$ is the sample autocorrelation coefficient of order j of the $\Delta \ln P$ series. A significant departure of this value from 0 would indicate absence of a random walk. In particular, significant negative values would indicate the variance of the qth difference increasing less than linearly with q. This situation, known as 'mean reversion', occurs when stock price changes are negatively correlated. This can arise in the presence of a zero-mean stationary component in the stock prices representing transitory deviations from the efficient market prices owing to "irrational bubbles in prices" and/or "large rational swings in expected returns" (Fama, 1991). According to the story told by Bagehot (1971) and Kyle (1985), dealers lose when trading with the informed investors, but recoup the losses by trading with the uninformed "noise" investors. Mean reversion can occur as the private information of the informed investors is gradually reflected in market prices.

Given a total of T observations, a test statistic using (4) is given by:

$$z(q) = \frac{(\sqrt{T-1})M(q)}{\sqrt{\theta(q)}} \qquad (5)$$

where $\theta(q) = \sum_{j=1}^{q-1} \left[\frac{2(q-j)}{q}\right]^2 \hat{\delta}_j$, $\hat{\delta}_j = \dfrac{(T-1)\sum_{k=j+2}^{T} (\Delta \ln P_k - \hat{\mu}_0)^2 (\Delta \ln P_{k-j} - \hat{\mu}_0)^2}{\left[\sum_{k=2}^{T} (\Delta \ln P_k - \hat{\mu}_0)^2\right]^2}$, and $\hat{\mu}_0$ is the sample mean of the first differences. Under the null hypothesis of a random walk, statistic (5) is asymptotically standard normal for any q, and is robust to both heteroscedasticity and non-normality. VR tests are typically carried out using this statistic.

The hypothesis of random walk cannot be rejected by the VR test if it is not rejected for *all* the selected q's. For a test at the 5% level, if we compared each |z(q)| with 1.96, the overall significance of the test would not be 5% as multiple variance ratios are involved in this comparison. Chow and Denning (1993) proposed a multiple variance ratio test by which the random walk hypothesis can be rejected at 5% significance only if $\underset{q}{Max}|z(q)| >$ SMM(0.05, m, v), the latter being the critical value with a 5% upper tail area of the

Studentised Maximum Modulus (SMM) distribution with m = k(k-1)/2 where k is the number of q's selected, and v = degrees of freedom (= T-k).[3]

Lo and MacKinlay (1989, p. 210-211) pointed out that a heteroscedasticity-robust Box-Pierce test could also be constructed using $\hat{?}_j$. In this case, the test statistic

$$Q = ?_{j?1}^{h} \frac{\hat{?}_j^{2}}{\hat{?}_j} \tag{6}$$

With an asymptotic chi-square distribution with h degrees of freedom could be used in the case of large samples.?

Stock prices and/or returns are typically found to be non-normal in distribution. This is not really a problem for our tests above if the sample is large as these tests are valid asymptotically even with non-normal errors. In the case of small samples, predictability of returns can also be checked by using the runs test of independence, which is a non-parametric test free of the normality assumption.

3. A Review of Empirical Evidence on Weak-Form Efficiency Tests

We will begin by looking at a few studies of developed stock markets. Campbell, Lo and Mackinlay (1997*)* used weekly stock returns data from 1962 to 1994 for the USA (NYSE-AMEX returns). The results of their VR tests show that the random walk model is rejected for the equal-weighted index, but not for the value-weighted index, suggesting that market capitalization or size can make a difference in these tests. Their results for the individual stocks on average tend to support the random walk hypothesis, company-specific noise being the likely reason for unpredictability of the individual returns relative to the aggregate portfolios.

Since mean-reverting behavior can lead to a rejection of the random walk hypothesis, investigations have also been carried out with returns data on stocks held for periods long enough to allow such behavior. For example, Poterba and Summers (1988) investigated monthly data on NYSE returns from 1926 to 1985, as well as annual returns data for the years 1871 to 1985. Results of their VR tests suggest that returns at long-horizons show negative serial correlation, i.e. mean reversion.

In contrast to the significant negative serial correlation that Poterba and Summers found for longer horizon returns, Lo and MacKinlay (1988) found no evidence against the random walk model in the four-weekly NYSE-AMEX returns for the years 1962 to 1985. Even the Poterba and Summers (1988) data do not really contradict the random walk hypothesis for long horizon returns as Chow and Denning (1993) demonstrated by applying a multiple VR test, which is the appropriate VR test to use.

Daily stock returns data can also be used to study market efficiency if data do not suffer from non-trading and spurious autocorrelation that can be induced by it. Groenewold (1997) examined share market efficiency of Australia and New Zealand using daily, weekly and monthly share price indices for the period 1975-92. Presence of a unit root was not rejected by the ADF and PP tests, but weak EMH was not supported by the VR test owing to correlated errors.

Chan, Gup and Pan (1992) used unit root and cointegration tests to examine the daily and weekly stock market indices in Hong Kong, South Korea, Singapore, Taiwan, Japan and the United States. They found unit roots in stock prices, but there was no evidence of co-integration among stock prices across countries. Hence, they concluded that the stock prices in major established Asian markets and the United States were weak form efficient individually and collectively in long run.

More recently, Cheung and Coutts (2001) failed to reject the random walk hypothesis for the Hong Kong Hang Seng Index with daily data over the period of January 1985 through June 1997, hence concluding that the Hang Seng Index is weak-form efficient.

Thus, developed stock markets generally appear to be weak form efficient, but the evidence summarized below for emerging stock markets – including the fairly new and the relatively older ones – are rather mixed.

Urrutia (1995) examined monthly stock price indices for four Latin American countries (Argentina, Brazil, Chile and Mexico) from December 1975 to March 1991 to test for the presence of random walk. Weak form efficiency was supported by runs tests, but variance ratio tests led to rejection of the random walk hypothesis for Brazil, Chile, and Mexico.

Ojah & Karemera (1999) revisited the study of Urrutia on the four Latin American emerging equity markets using both single and multiple VR tests. Monthly stock price indices expressed in US dollars for the period December 1987 to May 1997 were used. Results of single VR tests were like those of Urrutia, but the multiple VR tests led them to conclude that all four equity series followed random walk and that the markets were weak form efficient.

Smith, Jefferis and Ryoo (2002) used multiple variance ratio tests of random walk on eight African stock markets including the largest market (South Africa), five medium size markets (Egypt, Kenya, Morocco, Nigeria and Zimbabwe) and two small new markets (Botswana and Mauritius). They used weekly data for January 1990 to August 1998 except for Egypt and Nigeria, for which the series start in the first week of January 1993, and 1994 respectively. Their results show that only the price index of the Johannesburg stock exchange of South Africa followed a random walk.

Dockery & Vergari (1997) examined the random walk hypothesis for the Budapest Stock Exchange (BSE). They used weekly observations for the BSE share price index covering the period January 1991 to May 1995. Their VR test results indicated that the Budapest Stock Exchange was efficient in the weak form.

The existence of weak form efficiency in the Russian Stock Market was examined by Abrosimova and Linowski (2002) using daily, weekly and monthly Russian Trading System (RTS) index series covering the period from 1/9/95 to 1/5/2001. They conducted unit root tests and variance ratio tests to assess the predictability of the RTS index. ADF tests indicated presence of a unit root, but autocorrelation and VR tests supported weak form efficiency only in the case of the monthly index.

Empirical studies in testing of market efficiency of Asian emerging markets is not very extensive. The findings of the studies undertaken so far are also conflicting. Poshakwale (1996) investigated weak-form efficiency in India using the daily price index of the Bombay Stock Exchange over the period of 1987-94. Evidence based on runs test and serial correlation test suggested that the Bombay Stock Exchange was not efficient in the weak form.

Alam, Hasan and Kadapakkam (1999) applied variance ratio test to five Asian stock markets: Bangladesh, Hong Kong, Malaysia, Sri Lanka and Taiwan to test if these markets were efficient in the weak form. They used monthly value-weighted market indices from November 1986 through December 1995. Results of VR tests indicated that the index return series for Bangladesh, Hong Kong, Malaysia and Taiwan followed random walk, implying the existence of weak-form efficiency in those markets. The authors suggested that rejection of the hypothesis of random walk in the case of Sri Lanka might be due to a serious infrequent trading problem in that market rather than market inefficiency.

Lee, Chen and Rui (2001) examined daily returns for the Chinese stock indices, Shanghai A & B and Shenzhen A & B, for the period 1990 to 1997. The random walk hypothesis was rejected by both ADF and VR tests.

Mobarek and Keasey (2002) wanted to find out if the Dhaka Stock Exchange (DSE) was weak form efficient. Their sample included the daily indices of 30 of the listed securities on the DSE as well as the all-share index for the period 1988 to 1997. The indices were not adjusted for dividend, bonus and rights issues. Using a non-parametric test (the runs test of independence) as well as autocorrelation (Ljung-Box Q test) and auto regression tests, they concluded that the market index as well as an overwhelming majority of the individual indices did not follow a random walk.

4. A Brief History of the Dhaka Stock Exchange (DSE) and Data

The DSE was incorporated on April 28, 1954 under the name of East Pakistan Stock Exchange Ltd., but formal trading started later in 1956. On June 26, 1962, it was renamed as the Dhaka Stock Exchange Ltd. After separation of Bangladesh from Pakistan as an independent country in 1971, the activities of the Exchange were suspended in pursuance of the economic policy of the government at that time. Trading activities resumed in 1976 with only nine listed companies with a total paid up capital of Taka 137.54 millions (equivalent to US$ 2.75 millions approximately) on the board.

Since August 1998, the DSE has been providing automated screen-based trading facilities for its members, and all the buy or sell orders are now processed by a computerized trading system every day except Friday – the weekly holiday in Bangladesh – and the other government holidays. Normally, a client who wants to buy or sell shares opens an account with a broker. The system is designed to match the best buy and sell orders, and to confirm the deal automatically. After the trade, the broker sends a contract note called '*Howla*' giving details of the transaction to the client for settlement. Although DSE turnover has increased rapidly since automation, the trading system and facilities prior to that time were primitive by international standards.

The size of a country's security market is usually measured by market capitalization, and its liquidity by turnover and turnover ratio. Unlike other Asian countries, the size of the DSE market in terms of market capitalization and number of listed securities is relatively small, but the turnover ratio is fairly high. The position of Bangladesh in terms of these measures compared to other emerging markets in Asia in 1999 is shown in table 1.

TABLE 1: NUMBER OF LISTED COMPANIES MARKET CAPITALIZATION, TURNOVER AND TURNOVER RATIO IN SELECTED EMERGING STOCK MARKETS 1999

Country	No. of Listed Companies	Market Capitalization (US$ Million)	Turnover (US$ Million)	Turnover Ratio (%)
Bangladesh	211	865	789	83.0
Sri Lanka	239	1,584	209	12.7
Philippines	226	48,105	19,673	47.2
Thailand	392	58,365	41,604	89.2
Indonesia	277	64,087	19,903	39.8
Malaysia	757	145,445	48,512	30.9
India	5,863	184,605	122,247	84.4

Sources: Emerging Stock Markets Fact book: 2000, IFC, Washington.

The DSE has been growing rapidly since 1999. As of October 2002, there were 258 securities listed on the stock exchange consisting of 239 shares, 10 mutual funds and 9 debentures. Total market capitalization of all listed securities was approximately US$ 1.2 billions.

After the stock market crash in 1996, the policy makers took various steps to reorganize the capital market and to regain the confidence of investors in the market. The market is now comparatively more transparent due to self-regulation of the Exchange and close monitoring by the Securities & Exchange Commission (SEC). The Dhaka Stock Exchange is now being considered as one of the frontier emerging markets of South Asia.

DSE Price Indices and Returns

This study uses daily, weekly and monthly market prices and returns of the Dhaka Stock Exchange during the years 1990 to 2001. Starting from January 1990, the daily market price data cover the period up to 23 November 2001, while the weekly and monthly price data cover the period up to 21 November 2001 and 31 October 2001 respectively. The price indices for the period 1992 to 2001 were collected from Data Stream Advanced Version 3.5 developed by Data Stream International Limited. Data for the period 1990 to 1991 were taken from the daily price quotations (after adjustment for bonus and right issues) of the Dhaka Stock Exchange.

A plot of the monthly indices in figure 1 gives an idea of how the prices changed during the sample period. The market peaked in November 1996 (month 83 in graph).

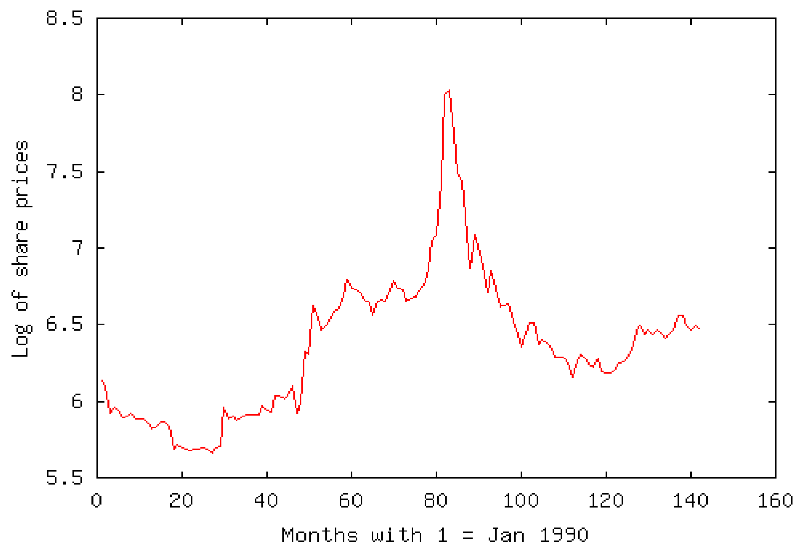

Figure 1 : Log of Monthly Share Prices, Jan 1990 – Oct 2001

Some summary statistics for market returns calculated as first differences of log prices appear in table 2.

TABLE 2: SUMMARY STATISTICS FOR DAILY, WEEKLY, AND MONTHLY MARKET RETURNS

	Total # of Observations	Mean	St. Dev.	Minimum	Maximum	Skewness	Kurtosis
Daily Returns Jan 90 - 23 Nov 01	3104	0.00009	0.0188	-0.3464	0.3264	0.472	105.123
Weekly Returns Jan 90 - 21 Nov 01	617	0.00045	0.0459	-0.3369	0.4604	1.040	29.137
Monthly Returns Jan 90 - Oct 01	141	0.00236	0.1070	-0.3508	0.5692	1.221	7.427

Weekly return is computed as the return from Wednesday's closing price index to the following Wednesday's close. If the following Wednesday's price is missing, then Thursday's price (or Tuesday's price if Thursday's is missing too) is used. The monthly return is computed as the return from the month end index. If the last day of the month is a holiday, then the following day's closing price is taken. If the following day's price is also missing, the index of the day before the month end day is taken.

Average stock returns in table 2 are all positive, but the distributions of returns are leptokurtic, i.e. more sharply peaked about the mean than a normal distribution, and positively skewed in all the cases. Non-normality of stock returns is a common feature of most stock prices, e.g. Poshakwale (1996) for the Indian market, and Smith, Jefferies and Ryoo (2002) for African stock markets.

5. Results and Analysis

Unit Root Tests

The daily, weekly and monthly Index series of Dhaka Stock Exchange are first tested for the presence of unit root in the log of the index using Augmented Dickey-Fuller (ADF) and Phillips-Perron (PP) tests as formulated in SHAZAM (Whistler, White, Wong and Bates, 2001). In both tests, a linear trend term is included. The null hypothesis for each series is that it is generated by a difference-stationary model against the alternative of a trend-stationary model. The lag length in the ADF test and the truncation lag in the PP test were chosen by SHAZAM as the highest significant lag order from either the autocorrelation function or the partial autocorrelation function of the first differences (i.e. the returns in this paper). The unit root hypothesis can be rejected if the t- test statistic is smaller than the critical value.

The results of the unit root tests reported in table 3 indicate that we cannot reject the null hypothesis of a unit root for any of the series by either test at the 5% level of significance; in each case the test statistic is not smaller than the critical value.

TABLE 3: TESTS OF UNIT ROOT IN THE DSE ALL-SHARE PRICE INDICES

	Total # of Observations	**ADF**	**PP**	**Critical Value @ 5%**
Log Daily Index	3105	-1.849	-1.262	-3.41
Log Weekly Index	618	-1.504	-1.332	-3.41
Log Monthly Index	142	-1.741	-1.683	-3.41

The presence of a unit root supports the weak efficient market hypothesis in the absence of autocorrelation in errors. Since the presence of a unit root is a necessary, but not a sufficient condition for a random walk process, we now proceed to a more definitive test of return predictability.

Variance Ratio Tests

Results of variance ratio tests are shown in table 4. Variance ratios were calculated at lags up to 128 for the daily index, up to lag 64 for the weekly index, and up to lag 32 for the monthly index. The variance ratios are reported in the main rows, with heteroscedasticity-robust test statistics, to test if the variance ratios differ from 1, given in parentheses immediately below each estimated variance ratio.

TABLE 4: VARIANCE RATIO TESTS OF DSE ALL-SHARE PRICE INDICES

	# of observations	At lag 2	At lag 4	At lag 8	At lag 16	At lag 32	At lag 64	At lag 128
Daily Index	3105	1.068* (2.884)	1.052 (0.425)	1.093 (0.489)	1.236 (0.961)	1.466 (1.397)	1.739 (1.722)	1.924 (1.718)
Weekly Index	618	0.991 (-0.085)	1.050 (0.230)	1.257 (0.765)	1.488 (1.099)	1.547 (0.976)	1.475 (0.686)	
Monthly Index	142	1.208 (1.382)	1.323 (1.124)	1.279 (0.632)	1.192 (0.323)	1.083 (0.113)		

*indicates significantly different from 1 at the 5% level

Under the null hypothesis that the variance ratios equal 1, the test statistics have a standard normal distribution. Test of any single variance ratio at the 5% level can be carried out by comparing the test statistic with critical value ± 1.96, but the appropriate critical values for a multiple variance ratio test are ± 2.69 for 7 variance ratios (the daily index), ± 2.64 for 6 variance ratios (the weekly index) and ± 2.57 for 5 variance ratios (the monthly index) from the table of critical values in Miller (1981, p.239).

Thus, the results in table 4 show that the null hypothesis of random walk cannot be rejected at the 5% significance level for the weekly and monthly indices, all the test statistics being inside the respective critical ranges. For daily data, the test statistic is outside the critical range for only the smallest (lag 2) of the seven lags. This is clearly a result of error autocorrelation at a lag of a day or two since we found previously that the daily index also had a unit root. In the presence of transaction costs, any error predictability over just a day or two is highly unlikely to offer profit opportunities to any investors.

Given the overall evidence above then, it is likely that the Dhaka stock market is weak form efficient. This result agrees with that of the VR test of the Dhaka market by Alam, Hasan and Kadapakkam (1999), but differs from that of Mobarek and Keasey (2002) who used daily data and relied on the Box-Pierce-Ljung test, which is a less powerful test of autocorrelations when errors are heteroscedastic.

Autocorrelation Tests Robust to Heteroscedasticity

To check the robustness of findings based on a Box-Pierce test of autocorrelations, we applied this test with and without heteroscedasticity adjustment to the daily Dhaka stock index. The results displayed in table 5 indicate that the null hypothesis of zero autocorrelations (i.e. weak form efficiency) could be rejected at any of the lags if the Box-Pierce tests weren't adjusted for heteroscedasticity, but not if the tests were made robust to this problem.

TABLE 5: BOX-PIERCE TESTS OF DSE ALL-SHARE DAILY PRICE INDEX
(Numbers within parentheses are the p-values)

	# of observations	At lag 2	At lag 4	At lag 8	At lag 16	At lag 32	At lag 64	At lag 128
Test not robust to heteroscedasticity	3105	14.196 (?0)	33.764 (?0)	37.351 (?0)	102.193 (?0)	164.156 (?0)	255.159 (?0)	429.337 (?0)
Test robust to heteroscedasticity	3105	0.003 (0.959)	0.003 (?1)	0.004 (?1)	0.008 (?1)	0.012 (?1)	0.020 (?1)	0.037 (?1)

Although a heteroscedasticity-robust Box-Pierce test was suggested by Lo and MacKinlay (1989) in the context of their Monte Carlo experiments, our study appears to be the first one to apply this test to stock market data. Results based on autocorrelation tests not corrected for heteroscedasticity typically result in rejection of the hypothesis of weak form market efficiency, e.g. Claessens, Dasgupta and Glen (1995), Poshakwale (1996) and Groenewold (1997). Given our results for the Dhaka market, we suspect that previous results based solely on autocorrelation tests not adjusted for heteroscedasticity may be reversed by the use of a heteroscedasticity-robust test.

Results for Individual Securities

In addition to the overall market indices, we tested the EMH also by using individual stock prices of the top 95 companies listed on the DSE, these being the companies with market capitalization above the median level for all the listed companies. Since thin or infrequent trading is a very common scenario of some individual shares on the DSE, we used monthly data to alleviate any bias in test results that thin trading can cause when using daily or even weekly data for individual companies (Lo & Mackinlay, 1988). Multiple VR tests were carried out for each of the companies individually. Weak form efficiency couldn't be rejected at the 5% level for all but one of them.

Cross-sectional means, standard deviations, minimum and maximum values of variance ratios for lags up to 32 are reported in table 6. For 13 of the companies, variance ratios were calculated only up to a lag of 16 as they had fewer than 64 observations.[4]

TABLE 6: SUMMARY STATISTICS FOR VARIANCE RATIOS OF INDIVIDUAL COMPANY MONTHLY INDICES

Variance ratios at	Number of companies	Mean	Standard deviation	Minimum	Maximum
lag 2	95	1.031	0.159	0.654	1.590
lag 4	95	0.984	0.268	0.306	1.733
lag 8	95	0.922	0.303	0.224	1.650
lag 16	95	0.811	0.367	0.160	1.729
lag 32	82	0.694	0.442	0.105	2.339

Although the sample standard deviations in table 6 cannot be used for any hypothesis tests, it is interesting to note that the sample means of the variance ratios at each of the lags differs from 1 by less than one standard deviation. This is a reflection of our previous result that variance ratios do not differ significantly from 1 for all but one of the companies.

Runs Tests

We also conducted runs test of independence between successive returns for the 13 companies with fewer than 64 observations. The standard normal runs test statistics ranged from –1.34 to 1.22, all within ?1.96 indicating that the null hypothesis of independence of returns (or weak form efficiency) cannot be rejected at the 5% level of significance for any of these companies.

6. Conclusions

Evidence in favor of weak form efficiency of the Dhaka Stock Market seems to be overwhelming from our investigations above using data for the years 1990 to 2001. All-share stock price indices at all the commonly used intervals – daily, weekly and monthly – are shown to have a unit root by the Augmented Dickey-Fuller and Phillips-Perron tests. Any predictability of returns arising from auto correlated errors is also ruled out by further Lo-MacKinlay variance ratio tests.

Individual share prices of all companies with market capitalization above the median level – 95 companies in all – were also examined. Company data at monthly interval were used in order to avoid any spurious autocorrelation arising from thin trading. The hypothesis of random walk or weak form efficiency again failed to be rejected for all but one of the companies. Share prices of 13 companies with relatively small sample sizes (63 or fewer observations) were also subjected to a non-parametric test of independence of returns (the runs test). The results of these tests confirm the presence of weak form efficiency.

Although a heteroscedasticity-robust Box-Pierce test was suggested by Lo and MacKinlay (1989) in the context of their Monte Carlo experiments, our study appears to be the first one to apply this test to stock market data. By applying this test, we have been able to resolve the apparently conflicting results reported by the only two studies of the Dhaka Stock Market carried out so far. Results based on autocorrelation tests not corrected for heteroscedasticity typically involve rejection of the hypothesis of weak form market efficiency. Given our results for the Dhaka market, we suspect that previous results based solely on autocorrelation tests not adjusted for heteroscedasticity may be reversed by the use of a heteroscedasticity-robust test.

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End Notes

[1] Dual listings of companies are allowed. For example, most of the companies listed at Dhaka Stock Exchange are also listed at Chittagong Stock Exchange.

[2] In the case of a small sample, it is typical to use the Box-Pierce-Ljung statistic Q = T(T+2) $\sum_{j=1}^{h} (T - j)^{-1} \hat{\rho}_j^2$ with the same asymptotic distribution.

[3] SMM critical values for v = ? can be read off the standard normal z table. For example, the 5% SMM critical value is the z value leaving an upper tail area of $0.5[1-(1-0.05)^{1/k}]$. Miller (1981, p.239) provides 5% SMM critical values for v ? 120.

[4] When lag is large relative to the sample size, a variance ratio test may have little power (Lo and MacKinlay, 1989, p.224). In their Monte Carlo experiments, Lo and MacKinlay chose the maximum lag size to be no more than half of the sample size.

Section 4
Global Trade and Trade Policies

Indicators Supporting Trade Policy Implementation in New EU Members

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Abstract

Slovenia as EU member will have to change foreign trade policy. Changes will be on two levels:

- **Adjustments of national trade policy objectives and instruments to obligatory EU trade policy framework,**
- **Utilization of the EU trade policy in helping domestic companies to increase trade with non-traditional markets outside the EU.**

Adequate trade policy requires supporting sustainable growth of national business sectors' competitiveness. Countries with similar characteristics of production have similar trade patterns and vice versa. Identifying similar trade patterns may suggest the country's characteristics most important in determining trade patterns and by those elements of their competitiveness relevant to trade policy implementation.

Reviled Comparative Advantage index indicates goods in which Slovenia presumably has pre-trade comparative advantage. Grubel-Lloyd index indicates industries with high level of intra-industry trade; assumingly they present industries with higher competitive ability. Calculated indicators help to effective adjustment of Slovenian trade policy within the EU.

Introduction

Slovenia as the new EU member (May 1, 2004) will have to focus on elaborating and implementing adequate and sizable changes in its foreign trade policy. Changes are to be on two levels:

- Adjustment of national trade policy in relation between Slovenian national trade policy priorities/objectives and the EU trade policy becoming its obligatory implementation framework,
- Utilization of the new EU trade policy environment (instruments like the EU bilateral, multilateral trade agreements, the EU trade financial supportive measures, the EU market protective measures like anti-dumping, anti-subsidy, etc.) to help Slovenian companies to expand trade with their non-traditional markets outside the EU.

To develop and continuously apply effective and allowed national trade policy within the EU integration's policy for a small country predominantly require ability and efficiency in supporting sustainable growth of the national business sectors' competitiveness. To follow such orientation firstly the trade policy implementation authorities have to have ability to assess, which national business sectors have a good potential to be growingly competitive internationally ?7?. Secondly creators of national trade policy in a small country within the EU must skillfully and consistently utilize all and every possibility (organized, and focused participation in all formal procedures, searching for supporters and partners within the decision making process, …) to voice and to integrate their policy objectives into the applied forms of the EU actual trade policy. Joining the EU will expose Slovenian national market and domestic producers to substantially increased competition coming from the third countries, provided that the EU foreign trade protection is applied on substantially lover levels than Slovenian before its joining of the EU. As known the trade briers are among the lowest between the WTO members, approaching applied tariff level of 0% for a number of manufactured products, and being on average applied level of 3,6%, compared by pre-joining applied tariff average level in Slovenia at 8,1%. The average applied tariff protection level for all products in pre-accessing Slovenia is at 9% and in the EU at 6,3%. Interestingly applied tariff protection in some sectors in Slovenia is lover as in the EU at present; agriculture in Slovenia 13,7%, the EU 16,2% and fishery applied tariff in Slovenia 5,9% and in the EU 12,4%. Beside such differences in applied tariff protection levels between Slovenia and the EU there will be other changes after the EU joining in relation to the foreign market access. Free trade agreements (FTA) concluded between Slovenia and other non-EU countries will cease to be effective due to acceptance of the EU trade policy. The change will be important for Slovenian companies and its trade especially in the cases where export is high and the respected countries have in force certain import trade barriers towards the EU. Such case is for instant Croatia where present FTA allows free exports to Slovenian companies but not to companies from the EU. Croatia is for years among most important trade partners for companies from Slovenia, it was the third largest market for exports in 2002. After May 2004 Slovenian exports as of a member of the EU to Croatia will be levied again by import tariffs. Similar effects but on smaller scale will happen with FYROM and B&H and some other countries. That is why the question of effective trade policy adjustment and especially of export promotion after joining the EU is such vital interest to Slovenia. Further we will concentrate mostly on the question on how a government can decide which industries could be successful in future, which could experience potential problems due to market opening and due to increased market entry barriers after joining of the EU. And above all which industries have potential to growth fast and steady in the new integrated environment especially by utilizing trade policy implemented by the EU. For those industries the national trade policy will have to elaborate arguments and ways, which will be suggested in the process of developing or applying the EU trade measures. On the other hand for those industries eventually applied specific promotion measures could be introduced on national level (as allowed within the EU general framework), together with information network supporting the companies seeking the information of the best applicable elements of the actual trade policy implemented by the EU.

To focus national trade policy in the EU framework properly, to avoid its negative impacts and to stimulate the positive once, specific objective measurement criteria/indicators could be of important value. Such indicators should group industries in above-mentioned groups, helping national trade policy to act most properly on the level of the EU trade policy during its preparation and during its implementation. On the level of specific allowed level of "internal" national trade policy such indicators cold help to optimize its results by directing eventual supports to the most promising export segments of national industries. Further we give some theoretical background to idea of selecting proper indicators, and some evidence of their analytical use in the case of Slovenian.

Theoretical background

Countries with business sector being more internationally competitive have higher potential to have positive and sustainable economic growth. International trade theory defines on different backgrounds the bases for business international competitiveness, creating as an aggregated value as well the over all national international competitiveness. A substantial part of nation's international competitiveness is based on factors deciding national comparative advantages. On the other side competitiveness of different national business sectors is based on comparative advantages derived from differences in supply side characteristics of a country. Then countries with similar characteristics of production[?] should have similar trade patterns. Conversely, countries with similar trade patterns should have similar characteristics. Hence, observing which countries have similar trade patterns may suggest the country's characteristics (e.g. factor prices, technology levels, location, etc.) most important in determining trade patterns ?1? and by that their competitiveness.

Expected positive effects of integration into the EU for all 10 new members in great deal depend on adequate utilization of the country's competitiveness derived from supply side characteristics of a country. Trade policies in real world tend to support or protect different industries with the intention to utilize comparative advantages by supporting the growth of partial and general increase of competitiveness. By using index of reviled comparative advantage (RCA= (Xij/Xwj)/(Xi/Xw))[2] we have searched for those goods in which Slovenia presumably have a pre-trade ("original" or "basic") comparative advantage. Trade policy in Slovenia must see to eliminate barriers or to support (in lines with the EU and WTO rules) industries with indicated RCA comparative advantages.

On the bases of intra-industry trade theory we studied a second approach to adequate selection of national industries, which could have low, high, growing or decreasing level of indirectly expressed competitiveness. We calculated the values of the Gruel-Lloyd index (G-L index)[3], measuring the degree of trade overlapping – trade between countries in the same or similar products ?8?. Taking in account methodological limitations (dilemmas about justifiable level of data aggregation ?3? by using STIC[4] which is product based, not an industry based, classification) and often suggested danger of subjective results interpretation, we will indicated industries with high level, or importantly changing level of intra-industry trade, measured by IIT index. Changes in the level of IIT are indirectly reflecting the changes in the industries' competitiveness provided that we assume that higher levels of intra-industry in open economy environment show the industry's ability to compete successfully on domestic and international markets.

Analytical results in relation to the used indexes for detection of industries with potentially high or strongly changing level of pre trade or intra-industry trade competitiveness could be useful to Slovenian foreign trade adjustments.

The same can be utilized in other accessing countries.

Pre trade competitiveness of Slovenian industries

We have calculated pre trade competitive advantage for all product groups on the level of two digits of the SITC for Slovenia in 2002. As the logic of the RCA index suggests the production groups with index level above 100 have a pre trade comparative advantage and by that companies related to such product groups are potentially more competitive internationally. The following table shows all products traded by Slovenia, which reviled in year 2002 trade comparative advantage, by having RCA index above the value of 100.

Table 1: PRODUCT GROUPS IN SLOVENIA TRADE WITH RCA INDEX OVER 100 IN YEAR 2002

SMTK no.	**SMTK description**	**RCA Index**
2	**1. Crude materials, inedible, except fuels**	
21	Hides, skins and fur skins, raw	274,6
24	Cork and wood	305,5
25	Pulp and waste paper	101,5
28	Metalliferous ores and metal scrap	174,1
3	**2. Mineral fuels, lubricants and related materials**	
35	Electric current	365,3
5	**Chemicals and related products, n.e.s.**	
52	Inorganic chemicals	113,0
6	**3. Manufactured goods classified by material**	
61	Leather, leather manufactures,	126,0
62	Rubber manufactures, n.e.s.	430,0
63	Cork and wood manufactures (excluding furniture)	467,0
64	Paper, paperboard and articles of paper pulp, of paper or of paperboard	156,7
65	Textile yarn, fabrics, made-up articles, n.e.s., and related products	144,5
67	Iron and steel	152,7
68	Non-ferrous metals	415,3
69	Manufactures of metals, n.e.s.	183,9
7	**4. Machinery and transport equipment**	
77	Electrical machinery, apparatus and appliances	176,0
78	Road vehicles	170,2
8	**5. Miscellaneous manufactured articles**	
81	Prefabricated buildings; sanitary, plumbing, heating and lighting fixtures and fittings, n.e.s.	376,6
82	Furniture, and parts thereof	778,3
84	Articles of apparel and clothing accessories	240,5
85	Footwear	100,6

Source: Statisticni urad Republike Slovenije and External and Intra-European Union Trade.

The largest number of products showing comparative advantage in Slovenian trade is the group 6, containing products classified by the material. Further calculations on the three digits SCTI levels disclose that most important products in this group are; car tires (SITC 625), other products from wood (SITC 635) and aluminum products (SITC 684). Wood products are logical choice due to high natural supply of wood in Slovenia. Aluminum as a product having comparative advantage in trade is less obvious choice on the bases of RCA index use. Namely aluminum is energy intensive product and Slovenia is not energy reach country. On the other side energy cost for large manufacturing consumers was in past years extremely low, while it was not market decided. Buy the privatization of parts of the electrical system in Slovenia and by introducing market environment on supply and demand side one could reasonably expect that comparative advantage of aluminum could be reduced in coming years. Car tires are expressing comparative advantage not due to the abundance of key needed inputs, which are not available in Slovenia, but most probably due to high productivity related to FDI made into the only Slovenian car tires producer.

To generalize according to different theoretical analyses ?2? and to our data in Table 1, comparative advantages are in small countries found mostly in products having standardized demand. Often these are semi- finished products where the tastes on the small domestic market have no impact on their production. In line with such assumptions are as well our indicated products in section SITC 2 and to large extend as well in section SITC 8. In section SITC 7 we can see the effects of high production specialization of one only producer.

Use of RCA index calculation to indicate product groups and by that indirectly industries with higher competitiveness potential to support trade policy implementation seem reasonable especially when some specifics of the economy and industry sectors are taken in to account too. In case of Slovenia such additional evaluation of the RCA results for the trade policy implementation is no doubt possible.

Intra Industry Trade and Slovenian Trade Policy

To investigate the usefulness of the theory of intra-industry trade by use of Grubel-Lloyd index (IIT index) calculations for the better focusing of the national trade policy some explanations must be given. The absolute level of IIT for the same year and same group of products is changing while we change the definition of a products group let says from two SITC digits to three or more. For total Slovenian trade in 1998 the IIT index on the level of two SITC digits was 76,15 but on the level of three digits was lower reaching only value of 61,06, calculation on level of 5 digits as expected further decreased IIT index to the value of 44,77.

The reasonable (de)aggregation of products in relation to SITC digits level maters for our intend. Not due to needed objectivity of the calculated level of the intra- industry trade on the bases of IIT index, but due to the need that product group defined by SCTI level resembles as much as possible the typical national industry. The tradition – first calculations made by Grubel and Lloyd and further tests ?4?, including our ?6?, suggest that for most of the objectives related to calculations of IIT index can be best suited by the use of three digits SITC level. Our calculations were made on that level of three digits. We may add that for the indication of product groups with potentially higher level of competitiveness, and what we need for focusing of trade policy, more than absolute level of IIT index matters its change through time. Growing level of IIT indexes indicates more intra-industry trade and by that more direct and not pre trade type of products group/industry competitiveness. Comparison of IIT index data for 1999-2002 and 1993-1998 give some insights into transitional structural changes in Slovenian production on one hand and on the other indicates product sectors with stable, increasing or decreasing level of intra-industry trade, hence of competitiveness change.

Table 2: IIT INDEX FOR SLOVENIA ON THREE DIGITS SITC LEVEL, 1999-2002

Sector / Year	1999	2000	2001	2002
0 Food and live animals	42,095	39,640	37,919	38,907
1 Beverages and tobacco	63,876	55,915	53,485	45,446
2 Crude materials, inedible, except fuels	43,787	38,848	44,674	43,843
3 Mineral fuels, lubricants and related materials	9,713	7,618	7,681	10,854
4 Animal and vegetable oils, fats, waxes	40,868	33,490	32,113	37,651
5 Chemical and related products	56,529	57,046	58,859	58,005
6 Manufactured goods classified by material	70,069	69,674	71,185	69,923
7 Machines and transport equipment	64,975	62,729	65,575	64,513
8 Miscellaneous manufactured articles	68,301	69,589	69,344	68,481
9 Commodities and transactions not included elsewhere in the SITC	9,794	15,589	13,733	87,715
TOTAL	**61,924**	**60,004**	**61,986**	**61,476**

Source: Calculated from data of *Statisticni urad Republike Slovenije.*

Table 3: IIT INDEX FOR SLOVENIA ON THREE DIGITS SITC LEVEL,, 1993-1998

Sector / Year	1993	1994	1995	1996	1997	1998
0 Food and live animals	52,136	50,155	43,747	42,948	42,989	44,936
1 Beverages and tobacco	70,562	67,048	81,217	75,200	68,168	58,897
2 Crude materials, inedible, except fuels	41,677	36,396	36,536	39,085	40,457	40,561
3 Mineral fuels, lubricants and related materials	56,489	11,924	9,076	11,484	11,428	10,519
4 Animal and vegetable oils, fats, waxes	44,772	36,140	32,247	39,339	56,803	45,631
5 Chemical and related products	55,059	59,551	61,189	56,572	55,340	55,898
6 Manufactured goods classified by material	65,241	66,888	66,819	67,690	68,027	70,597
7 Machines and transport equipment	63,010	63,749	64,858	65,474	63,668	61,198
8 Miscellaneous manufactured articles	51,991	53,899	57,690	70,578	70,879	70,124
9 Commodities and transactions not included elsewhere in the SITC	8,239	10,740	12,320	18,326	17,175	15,966
Total	**57,326**	**58,800**	**58,320**	**61,256**	**60,490**	**61,059**

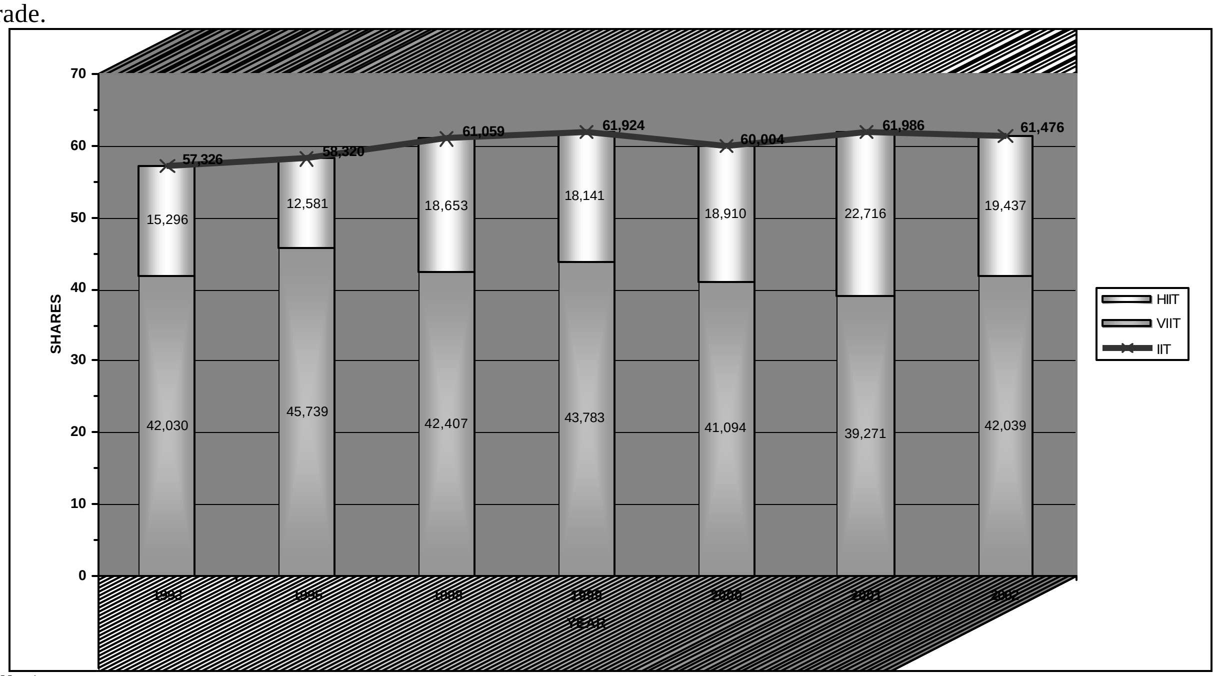
Source: *Boršic, 2000, p. 41.*

Values in table 2 for SITC 0-4 suggest that the intra-industry trade with these products is more or less decreasing. It could be interpreted that products in these groups are loosing their competitiveness in trade. Such results are not a surprise. For beverages and food products produced in Slovenia is for instance known that they have not have successfully introduce internationally – in Europe at least - recognized brand names. Intra-industry trade as a result of market differentiation of products and by that as specific element of their competitiveness is not really possible. Intra-industry trade based on non-differentiated product – as a result of seasonal differences in production is mostly not possible due to the same climate of Slovenia and markets in Europe. There are eventually some exceptions, like strawberries where natural environment in Slovenia allows them to be rape approximately 14 days before that happens in more northern European parts. For other products in SITC 0-4 shoving decreasing tendency of intra-industry trade the explanation is that form many there are no real natural potential available to be effectively produced in Slovenia. Growing openness of Slovenia and countries in Europe affects these product groups by decreasing of their intra-industry trade. From the trade policy view these groups of products are not future leaders in Slovenian trade on the other hand there further restructuring may cause increases in unemployment (coal mines are already closing down,..) and problems in the areas where farming is major activity. SITC 5-8 product group show in last years and in long ran (table 3 and table 2) some signs of increasing value of intra-industry trade. In last years (2001 to 2002) often as well some stagnation or stability. Anyhow in this broad product groups one would expect by de-aggregation to find groups of product with stable and dynamic growth of intra-industry trade. That could help to really better focus the adjusted trade policy in Slovenia. The strongest intra-industry development is observed in sectors SITC 6 (Manufactured goods classified by material) and in sector 8 (Miscellaneous manufactured articles). Companies producing products in these segments are potentially competitive and could be successfully included into the new trade policy environment of the EU.

We mentioned already different reasons for intra-industry trade and by that as well the basic explanation of the elements deciding about the higher or lover level of their competitiveness on international markets ?5,6?. These two basic aspects generate intra-industry trade by exchanging of two types of products;

- Differentiated products: similar products of the same sector who are different by quality elements (like more functions, higher speed, better known brand name,…etc.) and
- Non-differentiated products: similar products of the same sector with some functional specifics (like fresh fruit during winter, and similar).

First group of specifics creates so-called vertical type of intra-industry trade (VIIT) and the second the so-called horizontal intra-industry trade (HIIT)[5]. For Slovenia more important in the future will be vertical intra-industry trade.



* Note: For calcualtion the interval decided by *d=0,15 is used.*
Source: *Boršic, 2000, p. 44, and own calculation.*

Fig 1: SHARES OF HORISONTAL AND VERTICAL INTRA-INDUSTRY TRADE FOR SLOVENIA, 1993-2002*

For the past years – after 1993 - dominant part of Slovenian intra-industry trade was in its horizontal form. To the year 2001 vertical part in Slovenian intra-industry trade was gradually growing till 2002 when was slightly decreased. Growth of vertical intra-industry trade in general is a good sign indirectly suggesting that in general trade competitiveness was improving. Further analyses of horizontal and vertical intra-industry trade on level of 3 SITC digits could revile more closely product groups and indirectly businesses who succeeded to improve vertical part the most and who are by that potentially the most competitive part in the past Slovenian trade development. The decrease vertical of intra-industry trade at the end of the period analyzed could lead to different conclusions. One reason for the decline in vertical intra-industry trade in 2002 could be a result of introduced total openness for Slovenian trade for manufactured products towards the EU from January 1, 2001 onwards. Or decline in 2002 could suggest changes in production structure and by that a need to adjust the trade policy in the future, to help future growth in the share of vertical intra-industry trade.

However besides calculating the general IIT index to help the national trade policy to its effective orientation additional calculations of veridical and horizontal intra-industry trade indicators could further help to understand changes in trade competitiveness and by that directions for the national trade policy adjustments within the overall trade policy of the EU.

Marginal intra-industry trade and trade policy implications

Broad groups (SITC level of one digit) of products showing potential to be internationally competitive followed their growing or relative high level of intra-industry trade has to be broken into smaller groups for two reasons. By de-aggregating our IIT index expresses competitiveness of more and more similar products, and by that products structure is to reasonable extend approaching the business structure of the country. The second reason is related to already observe difficulties to interpret changes in vertical and horizontal intra –industry trade on the level of on SITC digit. We will combine this two reasons for intra-industry indicators calculation on the level of more SITC digits with additional need to understand better the dynamic change in the competitiveness measured by year to year change in intra-industry trade. We can follow such objective and additionally we can neutralize mentioned problem in relation between the level of IIT calculated and the change in the balance of payments. Calculation of so-called marginal index of intra-industry trade (MIIT)[6] is based on changes of export and import for product group in a selected period of time. The SITC 8 group of products has a high level of IIT index (tables 2 and 3), we were interested to see which products groups within this broad category have higher or lover levels of IIT on three digits level of SITC. Such calculation could help to more closely define product groups and indirectly businesses with potentially higher levels of competitiveness. In next table we add as well calculated values of MIIT to test how the indirectly measured competitiveness level of product groups was changed over a period of time – from 1999 to 2002.

Table 4: MARGINAL INDEX OF INTRA-INDUSTRY TRADE (MIIT) FOR SLOVENIA , 1999/2002

Sector		IIT 1999	IIT 2002	MIITB02/99
811	Prefabricated buildings	16,012	17,680	35,6
812	Sanitary, plumbing and heating fixtures and fittings, n.e.s.	50,448	87,239	27,8
813	Lighting fixtures and fittings, n.e.s.	84,357	86,798	90,6
821	Furniture and parts thereof; bedding, mattresses,……	37,314	36,553	35,1
831	Trunks, suitcases, vanity cases, etc.	53,356	79,369	92,9
841	Men's or boys' coats, capes, jackets, suits, blazers, trousers, shorts, …..	92,081	98,256	0,0
842	Women's or girls' coats, capes, jackets, suits, trousers, shorts, shirts, ……	84,987	96,289	0,0
843	Men's or boys' coats, capes, jackets, suits, blazers, trousers, …..	60,674	51,202	0,0
844	Women's or girls' coats, capes, jackets, suits, trousers, shorts, shirts, …..	95,706	92,125	11,0
845	Articles of apparel, of textile fabrics, whether or not knitted or crocheted, n.e.s.	97,863	86,109	0,0
846	Clothing accessories, of textile fabrics, whether or not	81,638	82,771	88,7

	knitted or crocheted (other than those for babies)			
848	Articles of apparel and clothing accessories of other than textile fabrics; headgear of all materials	99,378	73,363	23,8
851	Footwear	91,900	98,333	50,3
871	Optical instruments and apparatus, n.e.s.	24,996	52,215	0,0
872	Instruments and appliances, n.e.s., for medical, surgical, dental or veterinary purposes	70,783	79,359	99,1
873	Meters and counters, n.e.s.	25,027	26,131	31,3
874	Measuring, checking, analyzing and controlling instruments and apparatus, n.e.s.	76,284	89,354	74,0
881	Photographic apparatus and equipment, n.e.s.	74,704	77,620	92,7
882	Photographic and cinematographic supplies	42,352	46,695	57,4
883	Cinematographic film, exposed and developed, whether or not incorporating soundtrack or consisting only of soundtrack	24,934	0,604	0,0
884	Optical goods, n.e.s.	80,007	74,190	63,2
885	Watches and clocks	47,108	46,698	44,4
891	Arms and ammunition	15,722	22,401	28,0
892	Printed matter	78,933	82,548	89,8
893	Articles, n.e.s., of plastics	97,603	93,375	80,9
894	Baby carriages, toys, games and sporting goods	98,928	82,948	56,3
895	Office and stationery supplies, n.e.s.	84,946	75,861	50,0
896	Works of art, collectors' pieces and antiques	97,622	52,423	0,0
897	Jewellery, goldsmiths' and silversmiths' wares, and other articles of precious or semiprecious materials, n.e.s.	54,590	51,049	0,0
898	Musical instruments and parts	33,045	54,148	94,1
899	Miscellaneous manufactured articles, n.e.s.	55,211	56,858	60,0

Source: Calculated on data from Statistical Office of R. Slovenia.

For trade policy use data in table 4 add some additional insights into the search for those industry groups and indirectly business sectors, which show potentially, the most promising production potential related to their competitiveness to focus-selected instrument of national trade policy adequately. The growing or high value of the IIT as we noted already expresses potential for higher competitiveness level of production producing the specific group of products. Adding to that information as well the values of MIIT we can more securely judge which product groups in time effectively increase intra –industry and by that indirectly had grooving competitive potential in the time. To put it simply, high level of IIT is indication of competitiveness, if at the same time MIIT is high it shows that intra-industry trade in time was growing and by that indirectly as well the group of products competitiveness. If we take group of products 871- optical instruments, we notice high level of IIT in 1999 and its increase for 2002. While the MIIT for the same group of products is 0, explaining that for 871 products competitiveness on the bases of intra-industry trade was not achieved in fact. Increase of IIT in such case was caused by inter-industry trade changes, so not by increase of intra-industry trade which we relate indirectly to competitiveness, mostly by product differentiation.

Conclusions

Calculations of RCA index and of different forms of IIT index for Slovenian trade helped to detect sectors of production, defined by product groups on SITC bases, with some elements of high indirect competitiveness. Adjustment of trade policy in Slovenia will have to be substantial due to joining the common EU trade policy after May 1, 2004. It could be formally correct and if possible as well effective, so that Slovenian companies will be able to utilize positive elements of the EU trade policy on one side and to restructure most effectively following additional market openness. Calculated RCA indexes and IIT indexes in our paper suggest that they may be used to help national trade policy adjustments within the EU trade policy. Deciding about product groups relevant to get allowed support from the national trade policy based on calculated indexes need as well some caution and eventually introduction of some additional indicators to check relevance of the suggestions given by the calculated values of the used indexes. How-ever we are convinced that use of suggested indexes could at least narrow the areas of search where – on which product groups - to direct the part of activities included in the future Slovenian trade policy adjustments and implementation.

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Contact the Author for a list of References.

End notes

[?] We will limit our actual analytical effort to merchandise goods only. We assume that the same logic as for merchandised goods is valid for services in relations to conclusions explaining ways of enhancing competitiveness of a nation. Services are not analysed partially due to "tradition" generally used in other similar analyses and partly due to the problems with proper interpretation and availability of trade data on services.

[2] Xij country i's exports of commodity j, Xwj world export of commodity j, Xi country i's total export and Xw total world export.

[3] Intra Industry Trade (IIT) index or GLI index for the industry (i), with export X and import M has the form: $IIT = \left(1 - \frac{|X_i - M_i|}{X_i + M_i}\right) * 100$.

Index value is between 0 and 100, the last value denotes total level of intra-industry trade. When the index has the value of 0 trade is not within the analyzed industry but it is performed entirely between different industries – inter-industry trade. If the national level of intra-industry trade is calculated the calculation is made by:

$$IIT_{ag} = \left(1 - \frac{\sum_{i=1}^{n} |X_i - M_i|}{\sum_{i=1}^{n} (X_i + M_i)}\right) * 100$$

In the case of IITag results interpretation the problem is how to explain its value changes based on balance of payments change. We will not elaborate solution of the problem while we are interested only on specifying individual industries with growing, relative high or decreasing levels of the IIT.

[4] SITC – Standard International Trade Classification.

[5] Calculation of horizontal intra industry trade follows the assumption of transport and other costs, in our case assumed on the level of 15%=α. Intra industry trade is horizontal (HIIT) when coefficient value between sector's export and import is within the following interval: $1 - \alpha \le \frac{UVx_i}{UVm_i} \le 1 + \alpha$. *UVx* and *UVm* are unit export and import values for products of sector *i*. When the value of the export import coefficient is out of the specified interval the intra-industry trade has its vertical form (VIIT).

[6] Calculation of marginal intra-industry trade index is based on change of export ΔX and import ΔM in given time (two years for instance), ad follows the equitation: $MIIT = \left(1 - \frac{|\Delta X - \Delta M|}{|\Delta X| + |\Delta M|}\right) * 100$. The value of MIIT is 0 when marginal trade change is base exclusively on inter-industry trade and is 100 when the change is caused entirely by intra-industry trade.

Development of Foreign Trade Structure of Central European Countries to EU (Mainly German) Dominance

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Abstract

The fall of communistic regimes in Central Europe after 1989 started process of dramatic changes that had impact not only from geopolitical point of view (creation of new countries) but also on overall economic development of respective countries. These are currently on the way from centrally planned economies towards free market or liberal economies. This paper examines and describes significant structural changes in trade balance of central European countries in last decade, their natural orientation towards western European countries.

Introduction

The list of events that impacted the Central European countries after 1989 are as follows:

1. Germany took over leading role of major trade partner for central European countries from Russia and its share on exports as well as imports of these countries is rising. Another interesting fact is that except of Slovenia there is no significant second partner in international trade of CE countries.
2. The size of bilateral trade between Czech and Slovak Republic is very low and has tendency to decline.
3. There can be observed positive change in the structure of exports and imports among respective CE countries with an increase of exports and imports of machinery &transport equipment that means strengthening the position of these countries in the field with higher than average added value.
4. Food products exports of Poland and Hungary are continuously declining and thus reaching the role these countries are expected to play in the near future. (after joining the EU)
5. Imports of natural resources (natural gas, oil) from Russia stayed at the same level as before the change, which suggests crucial role of Russia in supply of these resources in the whole region.

Germany as a prime trade partner for Central Europe

Opening of economies significantly influenced the structure of trade partners of all CE countries. This was driven by two major factors at the same time. CE countries were loosing their position at important Russian market thanks to: i) worsening economic situation that culminated during the crisis in 1997 ii) requirement of mutual payments in hard currencies (DEM or USD) and iii) aggressive arising of new (western) competitors that had constrained access to the market before.

Germany became prime trade partner for the whole central Europe and its position is driven by following factors: i) its geographical location close to the CE region (common border with Czech Republic and Poland) ii) huge direct investments of German companies in respective countries, that generate increasing flow of semiproducts and final products between CE subsidiaries and their parent companies located in Germany. iii) bilateral trade and investment relations are not oversensitive to changes of political situation in respective countries as Germans concentrate their attention to the business questions and do not pay too much attention to political nuances.

Czech and Slovak Republic

Development of international trade structure of Czech and Slovak Republic has similar patterns due to the common history and very close relations from previous times. Tables 1 and 2 show significant growth of German share of both republics' exports as well as imports. Secondly, mutual trade between Czech and Slovak republic is still declining. This is due to: i) interruption of traditional production chains between Czech and Slovak companies ii) arising of the new and substitute producers &products at domestic market and iii) mutual loss of the advantages of internal market (i.e. duties, tax, quotas)

German's share on export of Czech Republic is significantly higher than the one on Slovakian. This may be caused (apart from other reasons such geographic location or amount of direct investments mentioned above) by the fact that semiproducts exported to Czech Republic from Slovakia are used in production and later on exported to Germany as parts of Czech final products.

TAB. 1: CZECH REPUBLIC – MAJOR EXPORT AND IMPORT PARTNERS

	Exports				Imports			
	1st partner		2nd partner		1st partner		2nd partner	
	Country	%	Country	%	Country	%	Country	%
1993	**Germany**	**26**	**Slovak Rep.**	**21.5**	**Germany**	**25.4**	**Slovak Rep.**	**17.4**
2001	**Germany**	**38,1**	**Slovak Rep.**	**8,0**	**Germany**	**32.9**	**Russia**	**5,5**
2002	**Germany**	**36,43**	**Slovak Rep.**	**7,7**	**Germany**	**32,47**	**Italy**	**5,47**

Source: CESTAT Statistical Bulletin, 2001

Czech Statistical Office 2002

Eastern European Consensus Forecasts, July 2003 - e-mail edition; Consensus Economics Inc., London, United Kingdom

TAB. 2: SLOVAK REPUBLIC – MAJOR EXPORT AND IMPORT PARTNERS

	Exports				Imports			
	1st partner		2nd partner		1st partner		2nd partner	
	Country	%	Country	%	Country	%	Country	%
1993	**Czech Rep.**	**42.4**	**Germany**	**15.2**	**Czech Rep.**	**35.9**	**Russia**	**19.5**
2001	**Germany**	**27**	**Czech Rep.**	**16,6**	**Germany**	**24,7**	**Russia**	**14.8**
2002	**Germany**	**26**	**Czech Rep.**	**15.2**	**Germany**	**22.6**	**Czech Rep.**	**15.1**

Source: CESTAT Statistical Bulletin, 2001

Statistical Office of Slovak Republic, Monthly Report 12/2002

Hungary

Stable macroeconomics with manageable fiscal and current account deficits, environment open to competition and unproblematic political conditions offered by Hungary attracted high and fast foreign direct investments and these became major driver of trade structure changes. Russian importance as trade partner declined and reaches 1/3 of 1993 share only, while the one of Italy is growing.

TAB. 3: HUNGARY – MAJOR EXPORT AND IMPORT PARTNERS

	Exports				Imports			
	1st partner		2nd partner		1st partner		2nd partner	
	Country	%	Country	%	Country	%	Country	%
1993	**Germany**	**26.6**	**Russia**	**15.3**	**Germany**	**22.2**	**Russia**	**21.6**
2001	**Germany**	**35,6**	**Austria**	**7,9**	**Germany**	**24,9**	**Italy**	**7.9**
2002	**Germany**	**33,3**	**Austria**	**8,2**	**Germany**	**23,8**	**Austria**	**7,7**

Source: CESTAT Statistical Bulletin, 2001

Eastern European Consensus Forecasts, July 2003 - e-mail edition; Consensus Economics Inc., London, United Kingdom

Poland

While in other CE countries the significant changes of trade structure started only in 90-ties, Poland (and to some extend Hungary) is an exception to the rule. Its structural changes started as early as in 80-ies after the different political development. As a result of these differences trade relations of Poland with USSR weakened and to some extend were replaced by its orientation towards Germany and other western European countries.

Tab. 4 shows that during last years considerably high trade share of Germany on Polish exports and imports stayed flat in recent years.

TAB. 4: POLAND – MAJOR EXPORT AND IMPORT PARTNERS

	Exports				Imports			
	1st partner		2nd partner		1st partner		2nd partner	
	Country	%	Country	%	Country	%	Country	%
1993	**Germany**	**36.3**	**Netherlands**	**5.9**	**Germany**	**28**	**Italy**	**7.8**
2001	**Germany**	**34,4**	**France**	**5.4**	**Germany**	**24**	**Russia**	**8,8**
2002	**Germany**	**29,9**	**Italy**	**5**	**Germany**	**28,7**	**Italy**	**8,1**

Source: CESTAT Statistical Bulletin, 2001

Eastern European Consensus Forecasts, July 2003 - e-mail edition; Consensus Economics Inc., London, United Kingdom

Slovenia

The situation of Slovenia is unique compared to the rest of CE countries. It did not have significant trade contacts with Russia and thus it was not hurt by Russian crisis. After the separation from Yugoslavia, Slovenia very quickly oriented itself to western European countries. Slovenia is the only CE country that has another strong EU neighbour (Italy). The trade share of Italy is naturally increasing after some original mutual political conflicts had been removed.

TAB. 5: SLOVENIA – MAJOR EXPORT AND IMPORT PARTNERS

	Exports				Imports			
	1st partner		2nd partner		1st partner		2nd partner	
	Country	%	Country	%	Country	%	Country	%
1993	**Germany**	**29.5**	**Italy**	**12.4**	**Germany**	**25**	**Italy**	**16.2**
2001	**Germany**	**26,2**	**Italy**	**12,5**	**Germany**	**19,2**	**Italy**	**17.7**
2002	**Germany**	**24,8**	**Italy**	**12,4**	**Germany**	**19,2**	**Italy**	**17,9**

Source: CESTAT Statistical Bulletin, 2001

Slovenia in Figures 2003, s. 51; Statisticni Urad Republiki Slovenije;www.stat.si

Change in the structure of exports and imports

Structural changes of exports and imports of CE countries are also dependent on forces behind them. The tendency of respective economies to change their production structure is driven by: i) an attempt to produce products with higher added value and ii) foreign direct investments that created new capacities and provide local subsidies international marketing channels and thus assured demand for products manufactured in CE.

Looking at structure of exports, “Manufactured goods classified chiefly by materials” was the dominant commodity group exported from all CE countries except Hungary. The outcome of the shift in the exports structure was steadily growing share of machinery and transport equipment on total exports in the whole region, while share of all the other commodity groups on total exports was falling. The shift has different intensity in respective countries. Tab. 6 shows that the portion of this commodity group on total exports in Hungary and Slovakia more than doubled in last 8 years; while in Slovenia it grew only slightly. This is due to fact that the structure of Slovenian exports had from the beginning healthy structure.

TAB. 6: SHARE OF MACHINERY AND TRANSPORT EQUIPMENT ON TOTAL EXPORTS (IN%)

Country	1994	1995	1996	1997	1998	1999	2000	2001	2002	Index 2002 vs.1994
Czech Rep.	**25.9**	**30.4**	**32.7**	**37.7**	**41.3**	**42.4**	**43.5**	**47,3**	**48.6**	**187**
Slovak Rep.	**19**	**20.4**	**21.8**	**28**	**37.4**	**39.5**	**39.4**	**38,5**	**38.8**	204
Hungary	**25.6**	**25.6**	**26.3**	**45.1**	**52**	**57**	**58.8**	**57,6**	**58.1**	226
Poland	**19.8**	**21.1**	**23.2**	**21**	**28.4**	**30.3**	**33.4**	**36,2**	**38.2**	**192**
Slovenia	**30.3**	**31.7**	**31.4**	**33.6**	**36.4**	**35.5**	**35.6**	**36,1**	**38.0**	**119**

Source: CESTAT Statistical Bulletin, 2001

The same shift can be observed in the structure of imports within the region. However, the shift was not that strong as it was in the structure of exports. Tab. 7 shows that the share of machinery and transport equipment grew most significantly in Hungary while in Czech Republic and Poland it grew only slightly. Growing positive difference between the export and import shares of machinery and transport equipment means growth of added value created in respective countries and this has also positive impact on development of respective industry.

TAB. 7: SHARE OF MACHINERY AND TRANSPORT EQUIPMENT ON TOTAL IMPORTS (IN%)

Country	1994	1995	1996	1997	1998	1999	2000	2001	2002	Index 2002 vs.1994
Czech Rep.	**35**	**37.1**	**38**	**38.5**	**39.4**	**39.6**	**39.6**	**42,2**	**42.6**	**122**
Slovak Rep.	**27.7**	**31**	**33.1**	**36**	**40**	**37.7**	**35.5**	**37,6**	**37.3**	**134**
Hungary	**34.1**	**30.8**	**29.5**	**41.8**	**46.5**	**50.2**	**50.4**	**51,6**	**52.3**	153
Poland	**31.8**	**33.6**	**33.8**	**33.1**	**36.6**	**37,0**	**34.5**	**36,4**	**37.8**	**119**
Slovenia	**28.8**	**29.9**	**33.6**	**36**	**38.3**	**38.2**	**36.4**	**33,6**	**34.6**	**120**

Source: CESTAT Statistical Bulletin, 2001

Food production of Poland and Hungary

Tab. 8 suggests another important pattern. We can observe continuous decline of "food and beverages" commodity group share on total exports of Poland and Hungary. In last 7 years it fell nearly 35% in case of Poland and reaches only 40% in case of Hungary. Thus the structure of both Poland as well as Hungary converges to the average of their neighbor countries. Major forces behind this dramatic decline of food products exports are: i) quotas posed on food products by EU and ii) loss of comparative advantage of extremely low prices due to overall increase of inputs prices. Thus food products are becoming less attractive for foreign markets.

TAB. 8: SHARE OF FOOD &BEVERAGES ON TOTAL EXPORTS (IN%)

Country	1994	1995	1996	1997	1998	1999	2000	2001	2002	Index 2002 vs.1994
Poland	**11.5**	**9.9**	**9.9**	**12.2**	**10.4**	**8.9**	**7.7**	**7,7**	**6.7**	58
Hungary.	**18.5**	**20.3**	**16.1**	**12.8**	**10.5**	**8**	**7.1**	**7,5**	**6.3**	34

Source: CESTAT Statistical Bulletin, 2001

Russian natural resources imports to CE

Due to instability caused by weakening economy the share of Russian imports from CE declined significantly in last years. However, Russia preserved its position in exports of natural resources to all CE countries. Attempts of CE countries to increase their exports to Russia and thus pay at least part of their natural resources imports failed and partly success of Poland to increase exports turned against Polish companies after the 1997 crisis when these ended up with unpaid receivables.

The dependency on Russian natural resources imports to CE creates high exchange rate risk. This is due to the fact that all payments for natural resources are in USD while majority of CE revenues are in Euro as they come from trade with Eurozone.

Conclusion

Despite recent changes in CE exports and imports and strong position of Germany that thanks to its location and other reasons mentioned above achieved superior position in bilateral trade, the future is not as clear as it seems to be. Now the question is whether other countries will follow the way Germany pioneered, or not. There is one very interesting fact; cumulative capacity of economies of France, Italy and Great Britain is 2 times higher than the one of Germany however their cumulative share on CE exports and imports reaches barely half of the German's one. Are these countries able to overcome their mental barrier that prevents them from trade and investments in CE or it is just geographical location of Germany that gives comparative advantage to it?

Close look at trade partners of respective CE countries reveals that bilateral trade among these countries is very low. If geographical location is comparative advantage, there are probably other barriers to the trade. One of them is probably very similar structure of the industry that produces variety of supplementary products but a lack of complementary products that could strengthen basis for bilateral trade.

Generally, the industry structure of CE countries has successfully undergone positive changes that can continue in case accession process will proceed smoothly. Spontaneous integration of CE economies to EU structures already started. Via FDI and increasing exports and imports CE economies are naturally becoming part of "New Europe" despite official date of EU enlargement even hasn't been announced.

Despite significant decline in exports and imports of Hungarian and Polish food products due to reasons mentioned above these countries have good prerequisites and tradition to stay strong in this industry. Moreover, joining EU will remove artificial barriers to their exports and after modernisation, reorganisation and capital influx to agriculture both countries can play important role in this industry in the future.

Russia plays and will play even more important role in supplying CE countries with natural resources (oil, natural gas/. It will even strengthen its position after new gas pipeline is completed. This means persisting threat of exchange rate risk mentioned above.

Currently the substitution of Russian natural resources supply is not economically advantageous. In spite of this fact CE countries should consider diversification of their demand in the future. After stabilisation of Russian economy should all CE countries try to cover at least part of their imports by exports to Russia. As Germany has very good position at Russian market part of the export can be incorporated in exports of German companies.

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Is there Convergence between North America Free Trade Agreement Partners?

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Abstract

Mexico has already gone through two decades of macroeconomic reforms. Among these, the liberation of the economy and its opening has been essential. They were accompanied by political and institutional reforms as well, and these were equally important. All of them were undertaken with the same final goal: speeding up sustained growth, reducing internal gaps and strengthening political democracy. The NAFTA agreement included the specific goal of reducing migration toward the United States, an objective that could be achieved if the convergence between these two economies were under way. The convergence process was to be invigorated by both foreign trade liberalization and structural reforms.

Introduction

This work is part of a more extensive one, an analytical effort exploring the impact of trade reforms on the absorption of domestic factors, productivity and growth. An increment in exports presupposed a more intensive use of the abundant labor factor, in other words, unqualified labor force. As export rates expanded, the demand for this resource would increase and wages would also rise. Moreover, if workers augmented their productivity as a result of being transferred to activities enclosing more comparative advantages, and due to educational improvement, workers' remuneration would increase as well. However, remunerations to capital would not grow to the same extent. The gap dividing Mexico and the United States would be reduced, and migration would lose incentives. In the Mexican scenario, these effects are not clearly settled down.

This work analyses the convergence between Mexico and the United States within the NAFTA framework. It is organized and divided into the following sections: In the second section, convergence issues are discussed. The third section provides several definitions of convergence, and presents quantification methods. In the fourth section, the evolution achieved by the NAFTA region is shown through a long term perspective including pre-opening and pre-NAFTA experiences. Having found the presence of convergence between 1945 and 1982, as well as a gap amplification during the 1983 –2001 period, the fifth section poses a growth model for the three economies, with the aim of explaining the causes for divergence. In the sixth section, the very sources of Mexican economic growth are explored. Finally, the seventh section comes up with a conclusion.

I. Convergence as the Goal of Economic Growth

When any given country introduces reforms to its development model, or when it starts negotiating multilateral or bilateral trade or integration agreements, the aim is to overcome the obstacles to its economic growth and advance toward the more developed ones. To speed up growth and shorten distances between member countries, preferential treatment needs to be granted to the less developed economies (GATT and WTO). In multilateral negotiations, as well as in regional integration, preferential treatment has been conceived to create mechanisms of convergence and to stabilize the agreements.

Concerns about the different dynamics attached to per capita incomes between countries have been a constant discussion-matter of growth theories, and they have been synthesized into multiple growth models. Smith, Malthus and Ricardo have looked into the causes that allow population to increase welfare, and ever since, these have constituted an essential part of the economic thinking. Recently, analyses on the correlation between the changes in trade policies, the regional integration programs, and convergence rates, have been studied in depth. It has been assumed, without much theoretical nor empirical foundation, that economic liberalization, and a more intensive trade integration among countries, should raise trade volume, affect rates of growth, and reduce income unevenness. Supposedly, there is a direct rapport between trade liberalization and convergence rates. This conclusion can be discussed when observing that convergence can occur in "sufficiently similar regions, of the same country, and less clearly, among nations integrated through commerce", Bergg and Krueger (2003). Nonetheless, these authors conclude that poor countries and regions may grow faster than the rich if their economies are sufficiently open and integrated. For OECD countries, several authors conclude that convergence has actually shown up since World War II. When it comes to the European Union, convergence was clearly revealed when the Treaty of Rome took place in 1958 (Ben-David, 1993; Olivera et al, 2003). Other authors suggest that convergence goes back to the end of the 19th century, and also covers countries not being part of the EU nor of the European Free Trade Association EFTA (Quah, D.1995; Slaughter 1998; Rodríguez and Rodrik, 1998). Trade has not come into view as the main catalyst for the convergence registered between EU countries. More than that, the process slowed down soon after the Treaty came into effect, and trade could enhance more divergence (Slaughter 1998 y 1987).

According to Rodríguez and Rodrik (1998), the direct rapport between the opening of an economy, foreign trade, and the cut down in the dispersion of countries trading with each other (subject-matter of many theses), is based on the postulates that countries open to external exchange speed up their growth. Since it has been taken for granted that poorer countries have preserved severe restrictions to external exchange, it is possible to conclude that their opening has to induce higher growth when they are compared to those that had previously undergone an opening-like process. In that sense, increasing exchange and opening economies to international competition has an important influence over convergence rates, affecting them with the very same devices that accelerate economic growth: the increase in investment efficiency, growth with constant return-rates due to major market access, higher domestic savings and external flow of capital rates, and strict domestic discipline when handling macroeconomic policies (Bergg and Krueger, 2003).

Measuring convergence has not been a serious methodological problem, nor has it entered into debate. This controversy emerges from the very sources of convergence and from the possibility of isolating the effects of each variable in the per capita GDP dispersion and its swiftness to grow. Slaughter (1997) provides an approach different from that presented by Barro and Sala-i-Martin (1992) and all the research work based on the Solow Model. According to Solow and his supporters, the convergence of growth of *per capita* GDP is a result of the differences in capital accumulation rates financed by domestic savings. Therefore, the effects produced by the accumulation of capital in international trade and rates of growth are put aside.

Barro and Sala-i-Martin (1995) studied the convergence process designed for American Union States, regions of Europe, prefectures in Japan, and OECD countries from 1952 up to 1960. Their results suggest the existence of an absolute convergence rising up from per capita GDP rates of growth, being the rates of poor countries and regions higher than those of the rich. This happens only when the economies are sufficiently integrated into each other.

Sachs and Warner (1995) graphed the GDP/worker rhythm of growth and the per capita GDP logarithm of 1965 for two countries classified in accordance with the opening degree defined by them. They found evidence showing that increments in convergence rates and products increase due to commercial opening impacts. These pieces of work, as well as the analysis of both authors, are intended to demonstrate that trade opening increases convergence and speeds up product growth in the countries involved. Quah (1995) raises doubts about the 2 % uniformity in convergence rates that can be proved through several analyses. Likewise, he reveals that this quasi-absolute 2 percent convergence law was brought about by the estimation method, having very little to do with economic growth dynamics and getting closer to the unitary root in time series. Using a theoretical model based on dynamic balances, he points out all problems attached to cross section convergence estimations and panel-type analyses. Moreover, he finds polarisation emerging from the convergence of rich and poor countries, and the disappearance of the middle-income group of countries. These statements explain why he has doubts about the existence and interpretation of the ?-convergence.

In the same study line, Arora & Vamvakidis (2001) explore the impact made by the American GDP growth on other economies. Convergence is used as an independent variable in the growth model. The per capita GDP logarithm shown in the first year is a part of other series of explanatory variables of economic growth (e.g. population growth, investments in fixed capital, high school registration, inflation, governmental consume, international trade share of GDP, rates of growth in the United States, rates of growth in the rest of the world, among others). The transmission mechanisms of the multiplying effects of growth in the American economy are synthesized in trade, in exporting-importing effects, financial flows, technological spillovers, and the impact on sectors non-directly related to trade.

Olivera Herrera's work applies the classical Solow growth model and does not presume any opening or international trade impact on economic growth. He analyses economic convergence considering internal factors, and ponders these results considering trade effects and opening process. Among the inner determinants of growth, we can highlight the presence of investments in physical capital, population rates of growth, human capital stock, the existence of a technological mechanism of convergence, labor markets evolution and the stability of nominal inflation, public budget deficit, interest rates, and so forth.

Berg & Krueger (2003) have looked into a series of articles[i], focusing their analysis on demonstrating that trade opening constitutes an economic source of growth and has very positive side effects because it diminishes poverty. Without going too deep into this matter, they mention a debate over the measuring problems attached to commercial opening levels and the causality between trade opening and economic growth. Throughout their work, they tend to overestimate the effects produced by trade, since trade policies are just a part of a more extensive package of measures related to macroeconomic stability, direct foreign investment, internal markets liberalization, solid institutional market, corruption, bureaucratic quality, expropriation risks, etc. Nevertheless, to Berg & Krueger, poor regions and countries tend to grow faster than the rich if the first group of countries is well integrated into the second. This statement contradicts Slaughter's results (2001), since he did not find any forceful evidence demonstrating that trade liberalization has positive effects on the speed of convergence shown by countries. From their revision, Bregg and Krueger also conclude that poor countries may grow and reduce poverty levels if they are open enough to foreign commerce. However, this conclusion is rather forced, since none of these studies reveals the opening effects and trade expansion over poverty, nor do they prove the existence of free trade mechanisms diminishing the number of poor people.

Another analytical review on several articles discussing the correlation between trade, reforms, opening and growth was made by Rodríguez and Rodrik (1999). These authors question methodological problems, and the consistency of the statistical results used to assure that trade opening is closely related to economic growth. Likewise, they strongly point out that economists must be extremely cautious when it comes to presuming a direct connection between trade, growth and welfare.

In their original specifications, and applied to different or modified cases ?designed to unmistakably assert the strength of their results, Rodríguez and Rodrik prove Dollar's (1992), Sachs and Warner's (1995), Ben-David's (1993) and Edwards' (1998) models. This way, Rodríguez and Rodrik questioned this so-believed connection linking trade and growth, that is, the bond that these authors have been testing in some of their articles. In other words, they doubt the restrictive measures to trade, the effective exchange rate distortion index, and the real exchange rate variability index applied by Dollar. Due to its restrictive assumption and its high degree of sensitivity to any alteration in the model or index, the effective exchange rate variability index is of very little use. They specially focus on Sachs and Warner's work, and the five indicators which have helped them assemble their renowned opening index. According to Rodríguez & Rodrik, the fact that there are only two state exporting monopoly indicators and that the prize to black-market dollar does not exceed a 20%, settle on the opening index behavior. At the same time, the first indicator generates bias on estimations. The second, on the other hand, is not really a good trade policy measure, since it is also a proxy of other variables non related to trade policies. With regard to the positive correlation between opening, productivity growth and GDP stated by Edwards, Rodríguez & Rodrik demonstrated that this does not constitute a statistically absolute result, at least not in the case of a countries' cross section.

Baldwin (199?), in his review on this literature, confers significant weight to the critics made by Rodríguez & Rodrik. Nonetheless, in general he concludes that the opening of an economy is more favorable to economic growth than the economies orientated toward their inside or the autarchies. He inverts the correlation of causation and underlines that the increment in exports is more likely to be a consequence of economic growth rather than its cause.

II. What does Convergence Mean?

There are several definitions and menstruations on convergence. All of them aim the reduction in the differences of welfare levels, or in rates of growth between countries or regions within a State. In every case, convergence has to do with growth sources and the conditions and policies that trigger them.

Absolute convergence, or type-ß convergence (Barro, 1991 and Sala -i- Martin, 2000), indicates the process according to which the economies having lower income levels register rates of growth superior to those having higher per capita incomes. This implies, on one hand, that there is a negative correspondence between rates of growth of income from the starting year and the following years.

The sigma d convergence, a concept that must not be mixed up with the previous one, indicates that per capita rent dispersion between groups of economies tends to be reduced in time, and it is expressed as the reduction of the differences in GDP/C levels between countries or groups of countries (convergence clubs). This calculation is based on the standard deviation of natural logarithms of the per capita incomes of countries or regions. The existence of a reduction in the deviation, that is, when the deviation trend sign is negative, suggests the presence of convergence, the opposite to divergence. This concept involves that countries having a lower GDP/C will register rates of growth superior to those experimented by more developed countries. This study is usually prepared for a period of time which is long enough to allow the detection of movements toward convergence or divergence, and so as to determine whether these changes in trend are related to any particular incident. A good example could be found in trade liberalisation or in the instrumentation of an integration agreement (Arora and Vamvakidis (2001); Sala – i - Maritn (2000); Quah (1995); Quah (1995).

Another basic concept is conditioned convergence, as it incorporates the structural conditions of the stationary state of each economy. These requirements are essential for the poor economies to speed up their growth more rapidly than rich countries. To figure it out, it is necessary to define equations of growth, with different variables, according to each school.

IV. Are the NAFTA gaps getting narrower?

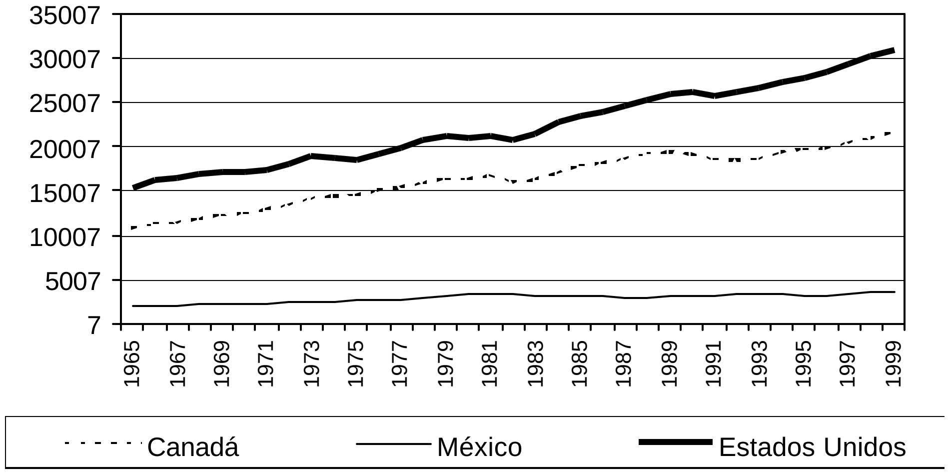
In this section, we will examine whether the NAFTA member countries have reached convergence after this agreement came into effect. We will also calculate absolute and sigma convergence and we will look deeply into the variables affecting the rates of growth of the three economies being part of the agreement. The path of growth of the per capita product in the three countries will be analyzed as well, during a sufficiently long period of time, so as to detect the historical trend and determine when and why there were changes in this path.

Even though there are a small number of countries, this analysis is important because of several reasons. These three economies were closely related to each other long before the NAFTA came into effect. In addition to a very intensive commercial exchange, investments and technological transfers, ?not to mention that migration has consolidated purely commercial relations even more, the links connecting these economies are of great importance, as suggested in the studies made by Krueger, and therefore convergence should appear as evident. Other than that, this analysis allows to test the suppositions stating that trade flows going from small countries (or less developed) to the rich are catalysts of convergence, as acknowledged by Arora & Vamvakidis (2001) and Krueger (2003).Given the great importance of the Mexican human capital investment, that has considerably elevated university labor supply (Romero and Puyana, 2003), it is possible to prove whether this factor promotes convergence in accordance with Ben-David & Kimhi's results(2000). It is also feasible to verify whether there is a positive correlation between opening and changes in trade policies of foreign investments and convergence.

To analyze the path of the member countries' GDP/C, first we would have to measure the sigma convergence for the 1930 – 2000 period, having Madisson's data (1998) on the 1930–1986 period as a base, as well as our calculations to complete the series up to the year 2000, all of them based on the World Bank's World Development Indicators (2002). After having found positive values to sigma convergence, that is, detecting divergence in a 56-year period of time, we will figure an equation of growth for the economies of the three countries, so as to identify the factors explaining the lack or the presence of beta convergence.

Graph 1 indicates the GDP/C trajectory for all three NAFTA member countries. At first sight, it is clear that the income gap registered in 1965 has been enlarged. It is possible to settle how much wider and when this amplification started by calculating sigma convergence.

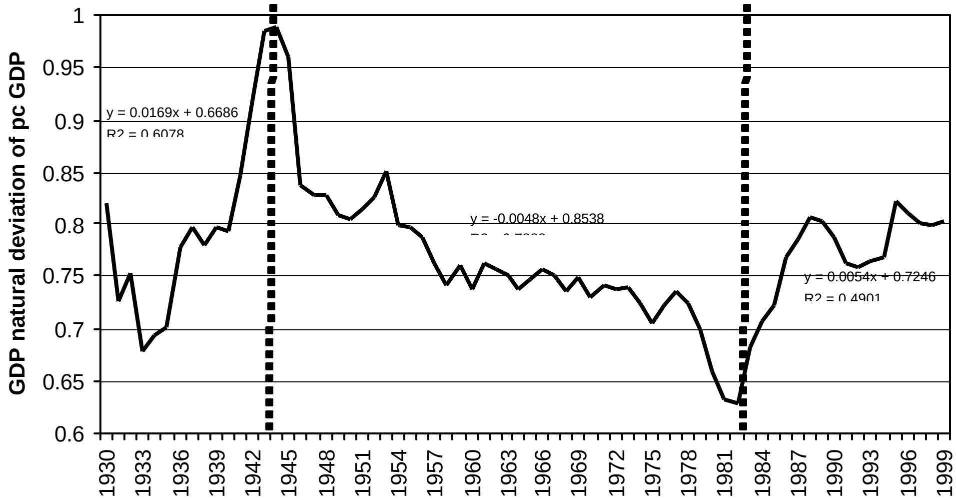
Graph 1
Per capita GDP of NAFTA countries (1995 dollars)



Source: Puyana and Romero's calculations based on World Bank, World *Development Indicators, 2002* CDR

As previously settled, sigma convergence suggests the rhythm speed of approaching or distancing of per capita incomes. Graph 2 presents sigma convergence for the 1930–2000 period of time, that is, the trajectory of the standard deviation value of the GDP/C natural logarithms belonging to the three countries. It is possible to distinguish three periods: 1930–44, when the prevalent trend was the augmentation of dispersion. During these years, the entire world was undergoing deep perturbations related to the 1929 crisis and the Second World War. The second stage, 1945–1982, includes the reconstruction efforts made by the Japanese and European economies, and the world economy reconversion from war to civil. During this period, the world economy grew like never before. This period is also known as the "golden age of Capitalism", (Scott, 1991). These have been the only years when the standard deviation value has been actually negative, that is, that these three economies expanded at a much accelerated rate. As a consequence, by 1982, they reached a point where the distance separating them was the smallest ever registered. The third stage, 1982–200, started with the debt-crisis outbreak and the reforms, and it ended with the 20th century, when these changes had been already established, the opening process had been settled down, and seven years after the NAFTA and the privatization process had been set in motion. During these years, the standard deviation augmented, and the three economies grew distant from each other. Neither the export push nor the NAFTA effects could change the sign in this trend.

Graph 2
Per capita GDP dispersion in NAFTA, and trends according to periods, 1930-1999



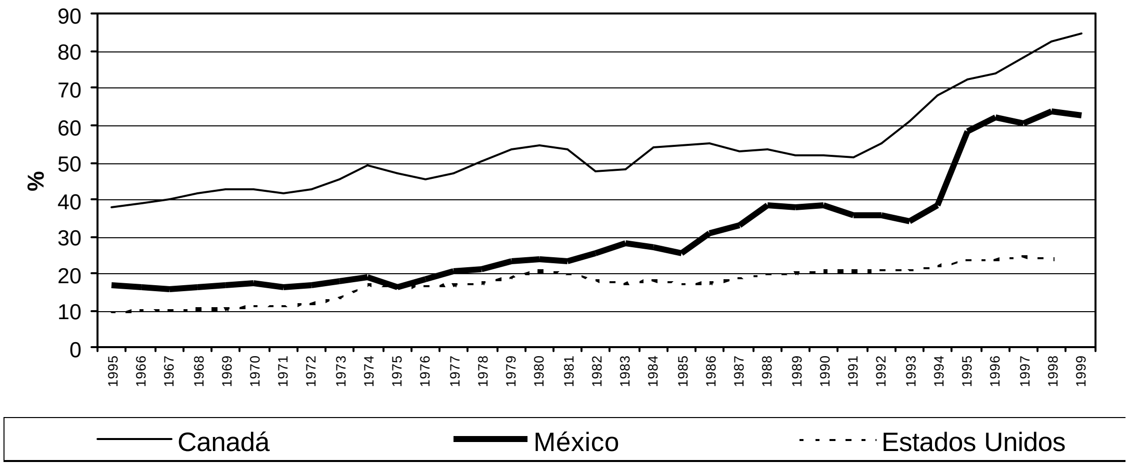
Source: Puyana and Romero's calculations based on Madisson (1999) and World Bank (2002)

Based on this exercise and given the sigma convergence values, it is possible to assert that convergence was shown exclusively during the fast growth period of these economies. This process took place throughout a stage marked by the second post-war reconstruction, when the world order was kept relatively closed (Promfett, 1999) and most of the developing countries, including those of Latin America, were applying with emphasis variations, import substitution (Krugman 2002), and there was convergence in Southeast Asian countries and developed countries, when the first still kept the most essential elements of their intervened economy model (Rodrik, 2003). To NAFTA members, convergence slowed down and started reverting in 1982, the year when the three countries, especially Mexico, liberated their economies. This turnabout in the course of events did not restrain this gap amplification, and results looked as if they could coincide with Quah's conclusions (1995) on the European Union case, –in this sense, growth and convergence precede the opening, and growth cannot accelerate convergence.

To go deeper in the analysis on NAFTA convergence, and due to the importance given to the opening in designing policies, and the argument sustaining the unmistakable existence of a positive correspondence between trade and sustained growth, we will explore the opening rate for these economies and their correlation with GDP growth. Our results reinforce the previous conclusions about the gap amplification between NAFTA member countries, especially between Mexico and the United States, from 1982 to 2000. These conclusions also provide Rodríguez and Rodrik's discussion with argumentation. For NAFTA countries, and particularly for Mexico, we found a very small or a non-existent correlation between the opening rate and the GDP growth. To come to this conclusion, we took as an opening measure the external rate of GDP[ii]. This indicator points out the opening degree of an economy, and ultimately that of productivity. It must be assumed that a successful procedure of trade liberalization, "to put prices right", should generate the sustained growth of the export-import rate with regard to GDP. If the export sector showed productivity higher than that of the rest of the economy, it would be logical for those countries to relocate the productive factors toward exports, revealing raises in the external rate of GDP, and higher rates of productivity and economic growth.

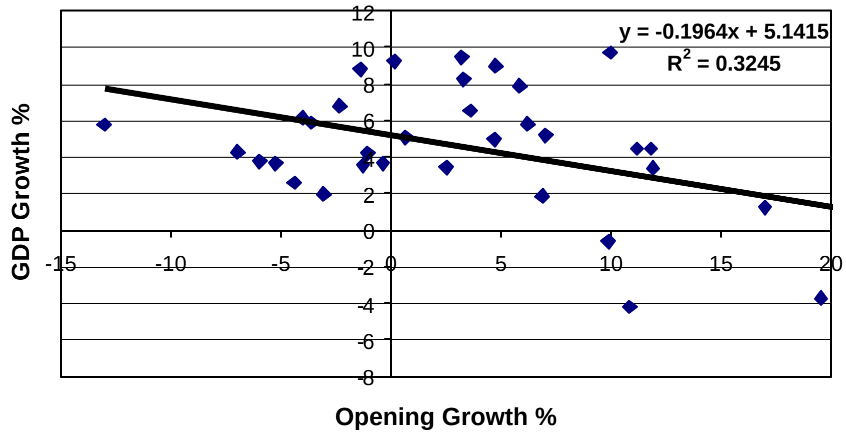
We will start out by mentioning that the American economy is less open than the Canadian and the Mexican (Graph 3). This statement, however, does not imply that the American economy is being more protected by tariff or non-tariff barriers. It only suggests that the American domestic market is wider, that Americans export a lesser amount of products, and that the external content of their economy is smaller, –due to a larger productivity, among other factors.

Graph 3
Trends in the opening coefficient of NAFTA countries



It is possible to detect a negative correlation between the high rhythm of growth of the GDP external rate shown by Mexico, and the expansion rate of its economy. Graph 4 presents the two-variable value of simple correlation results from 1960 to 2000. The trend sign is negative, and in the Mexican case, it suggests that the bigger the opening degree, the smaller the growth. There is no causation rapport between the variables, so it is necessary to go deeper into the elements explaining Mexican economic growth. The interesting thing, and therefore worrying, is that we did obtain a positive and significant correlation between the two variables in the Canadian case, and we actually observed a positive correlation (to a lesser extent) in the American case (Graph 1 and 2 of Appendix). Consequently, it is essential to explore Mexican economy's sources of growth and think of the causes explaining why this opening has not included higher rates of growth and convergence, as it was expected. Our results are in line with those of Slaughter y Quah (1995).

Graph 4
México: Correlation between GDP growth and opening growth



V. NAFTA SOURCES OF CONVERGENCE

Once it has been recognized that there was no convergence between NAFTA countries during the 1982-2000 period, we will establish the convergence sources in NAFTA countries. The first step is to calculate Beta convergence for the 1960-2000 periods. To do so, we include data on the variables of growth, and not exclusively on the per capita income of the three nations, shown in the previous exercise. Beta convergence suggests whether the less developed country in the starting year grows more rapidly in the following years. Beta convergence is calculated according to the following expression:

$\mathbf{GY_{Ti} = Co - ?\, LNY_{t-1} + U_t}$**.**

Where $\mathbf{GY_{Ti} = LN\ Y_t - LNY_{t-1}}$ is the difference of the natural logarithm of the per capita income of the i country in the t and t-1 periods of time, **Co** is the constant, and the ? parameter estimates absolute convergence. $\mathbf{LNY_{t-1}}$ is the logarithm of the per capita product in the initial year for each i country, and the std. error is represented by $\mathbf{U_t}$**.** The result goes as follows:

Beta Coefficient = -0.001390132. The beta coefficient sign is negative. As a result, there is divergence.

The results suggest that the initial GDP/C level does not determine convergence between NAFTA countries. Thus, it is essential to explore the variables explaining the trajectory of product growth in this region. That is why we estimated the per capita GDP growth for Canada, Mexico and the United States by defining an equation that integrates variables generally accepted by the specialists[iii].

Variables in the equation represent the values registered to each one of the three countries CRECY=C(1)+C(2)*YPCT+C(3)*INV+C(4)*GOB+C(5)*COM+C(6)*POB+C(7)*INF+?

Where:

CRECY	Rate of growth of the per capita GDP of each country,
YPCT	Logarithm of the per capita income in 1960 for the three countries
INV	Gross formation of tax expenditure in product for the three countries.
GOB	Tax expenditure share in product in the three countries. All expenses included, but investments. This is considered to be positive.
COM	Opening degree for the three countries.
POB	Population rates of growth for the three countries.
INF	Inflation rate for the three countries.
?	Std. Error

The results were the following:
Dependent Variable: **CRECY**

	Coefficient	Std. Error	T-Statistic	Prob.
C(1)	-5.210200	7.561826	-0.689014	0.4922
C(2)	0.458987	0.812938	0.564603	0.5734
C(3)	**0.591213**	**0.121737**	**4.856494**	**0.0000**
C(4)	**-0.389847**	**0.121795**	**-3.200844**	**0.0018**
C(5)	0.007223	0.020115	0.359077	0.7202
C(6)	**-0.953812**	**0.679500**	**-1.403697**	**0.1631**
C(7)	-0.068860	0.013614	-5.058015	0.0000

R-squared 0.302075

Convergence coefficient C(2), the per capita initial GDP, even though positive, is not statistically significant, which is consistent with the results obtained in absolute convergence.

The inversion C (3) is a significant element to countries' growth, this is caused by countries augmenting their participation at 1 percentage point in the product and it is likely to expect a 0.6 raise in the per capita income. Meanwhile government consume C(4) negatively affects the rate of growth[iv]. Commercial opening C(5) maintains a positive though not significant correlation[v]. This non significant effect is partly due to permanent deficits in balance of trade and the limited added value of exports, that is, the restricted usage of domestic factors, which triggers the coefficient and not the added value. In this sense, population growth C(6) keeps an inverse correlation with product growth, however it is not significant. Finally, the change in price levels C(7) is inversely related to the product rate of growth.

VI. Some Factors of Growth in Mexico

To determine the variables of growth of the Mexican economy, we selected the most common ones: demographic growth, physical capital investment, macroeconomic policies, trade opening, and the effect produced by Mexico's most important trade partner.
The equation to calculate Mexican GDP within the studied period is explained as follows:

$$YG = C(1) + C(3)*YGUS + C(4)*GOB + C(5)*INF + C(6)*INV + C(7)*COM + C(8)*POB + ?$$

Where:

YG is the per capita income rate of growth in Mexico,
YGUS is defined as economic growth in the United States,
GOB represents Mexican government consumption, in GDP,
INV is the percentage that gross fixed capital formation represents in Mexican GDP,
COM is the correlation of exports plus imports divided into the product,
POB is the rate of population growth, and last
? Std. Error

Results
The interrelation degree C(3) between the rhythm of growth of the United States and Mexico is positive and significant. Nonetheless, the positive effects of North American growth are attenuated by an inverse correlation, not significant though, between the opening degree C(7) and the variation of Mexican GDP, given than the export level has been constantly bigger than the Mexican exports.

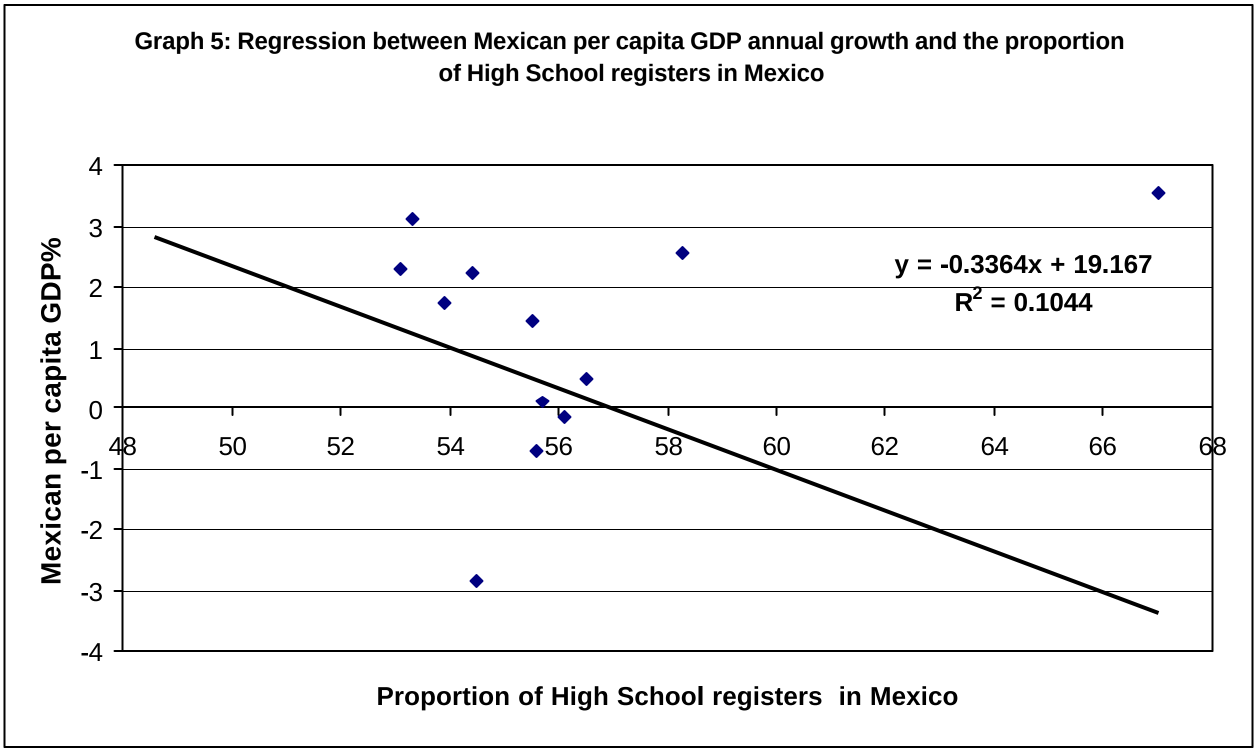
	Coefficient	Std. Error	T-Statistic	Prob.
C(1)	**-4.732378**	**8.765193**	**-0.539906**	**0.5928**
C(3)	0.582804	0.208366	2.797023	0.0084
C(4)	-0.958338	0.410303	-2.335684	0.0255
C(5)	-0.062201	0.015491	-4.015276	0.0003
C(6)	1.058073	0.256400	4.126647	0.0002
C(7)	**-0.019830**	**0.069807**	**-0.284074**	**0.7781**
C(8)	**-1.650799**	**2.001186**	**-0.824910**	**0.4152**
	R-squared		**0.554937**	

To a considerable extent, if governmental consumption C(4) increases in one percentage point in the gross domestic product, the inhabitant product growth will be reduced in one percentage point, approximately. This way, governmental consumption has negative effects more intensive than those registered by price variation C(5).

Gross fixed capital formation C(6) notably preserves the greater expansive effects on Mexican growth. In the Mexican case it is alarming that this has not presented a tendency increasing in the entire period.

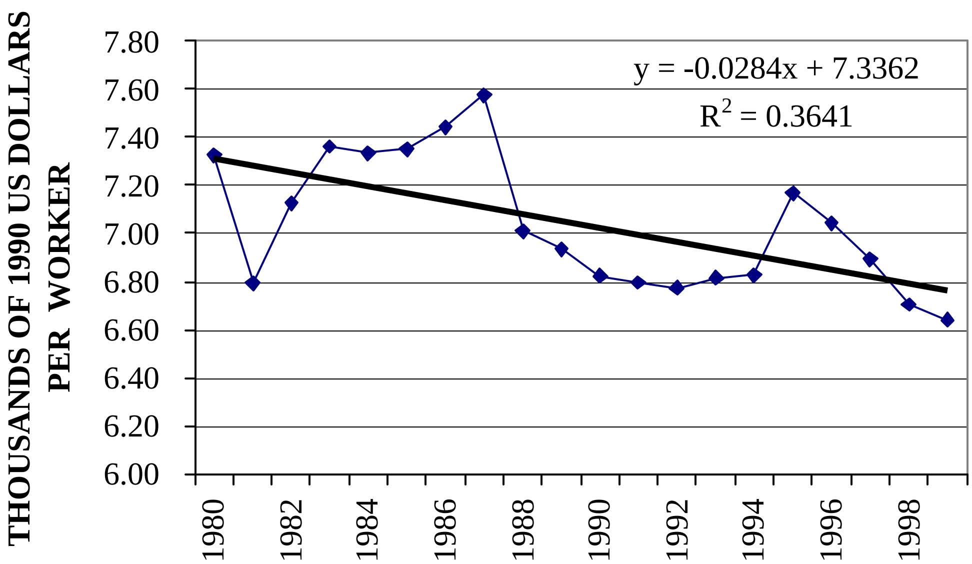
Education has been mentioned among the variables that supposedly have a positive impact on growth. According to Romer-type models of growth (1990), efficiency in human capital investment is one of the most important variables to determining the factors of growth. Even when it is true that there has been a remarkable improvement in the educational level of manpower, the outstanding thing about the Mexican case is the lack of a positive correlation between educational levels and growth, as shown in graph 5. A credible explanation to this phenomenon states that given the current Mexican labor market conditions of employers, education has turned out to be a mechanism to compete. Workers must accept low salaries and be in charge of activities inferior to their qualification. Attributable to these conditions, most of human capital investments are neither translated into higher productivity nor into better income levels (Romero y Puyana, 2003).

The per worker capital endowment is another variable that has impacted growth, and it is related to raises in productivity and economic growth. Even when it was not integrated into the equations, it is interesting to point out that, in the Mexican case, there has been a strongly negative trend during the 19809-2000 period of time (graph 6). This negative trend contributes to explain the inverse relationship between the educational level improvement of labor force and economic growth. Therefore, it suggests that better qualified human resources have been given access to less equipment and technology, both means to productivity and income growth.


Graph 5: Regression between Mexican per capita GDP annual growth and the proportion of High School registers in Mexico
y = -0.3364x + 19.167
R^2 = 0.1044
Mexican per capita GDP%
Proportion of High School registers in Mexico
4
3
2
1
0
-1
-2
-3
-4
48
50
52
54
56
58
60
62
64
66
68

GRAPH 6

VII. CONCLUSIONS



After more than fifteen years of economic reforms, and ten since the NAFTA was set in motion, the effects announcing a change in the model and the integration with the United States' economy have not yet crystallized. Even though it is true that there have been periods of growth for the Mexican GDP, these have only been sporadic, and have not been fully shown as a sustained approach to the income and welfare levels of Mexican NAFTA partners. To detect whether there is a trend toward convergence in per capita income of NAFTA members is the goal of this analysis.

The convergence registered from 1946 to 1980 has not been recovered, and today these economies are as distant as they were 20 years ago. It is important then to explore the determiners to this behavior, which was by no means expected neither by theoretical enlightenment, nor by those who had set their minds on demonstrating that convergence should have arisen once these economies had been integrated into the international market and more prosperous economies.

Our results provide those who have questioned the mechanical correlation between opening, foreign commerce and higher rates of growth with a standpoint. They also side with those who remained skeptical in the face of this positive and undeniable correlation between integration and convergence.

One of the causes for this lack of convergence between Mexico and its NAFTA partners lays on the fact that Mexican investments, measured by the GKF, have not been energized to an appropriate extent. For Mexican investments to be a convergence factor, they should have raised a much greater growth, and the GKF Coefficient of GDP should have grown notably distant from the values registered for the United States and Canada.

This analysis detected a very restricted or non-existent correlation between the opening of an economy and growth, in the Mexican case, and a positive relationship for Canada and the United States. It is essential to look into the causes for this phenomenon. One of the most likely explanations, –not explored in this work, is the weight of the imported content in Mexican exports, approximately a 60 per cent. Given these conditions, the multiplier factor of exports is reduced. Besides, when the income elasticity of imports is elevated, the external restrictions to growth are worsened.

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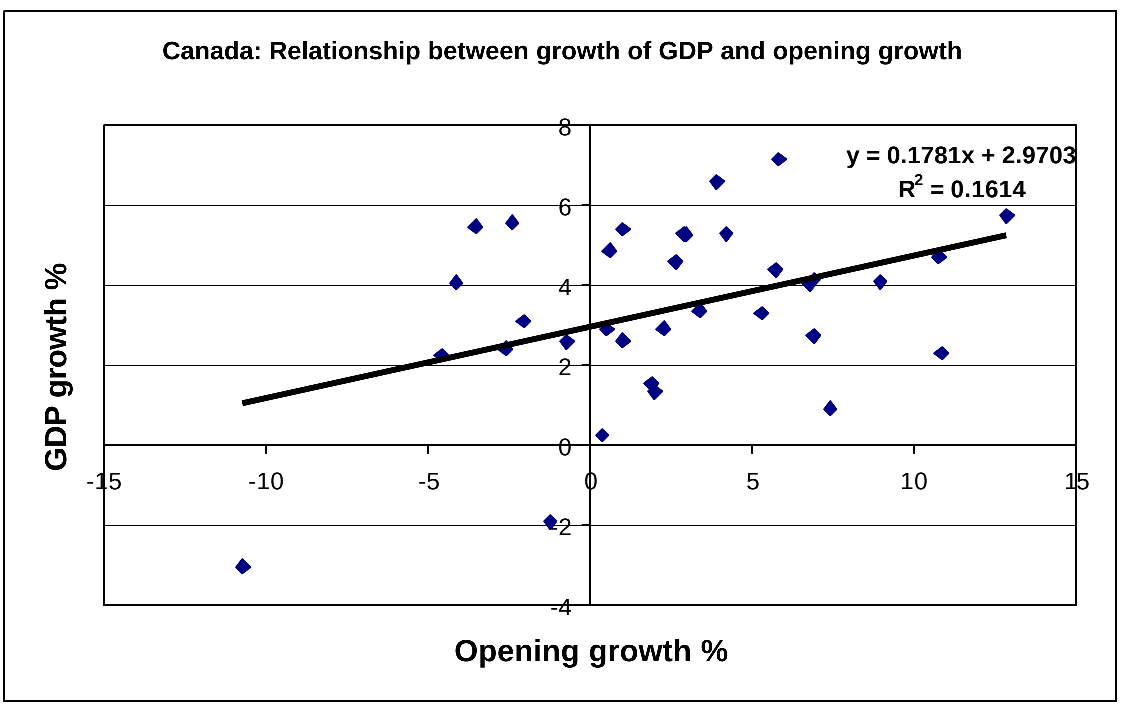
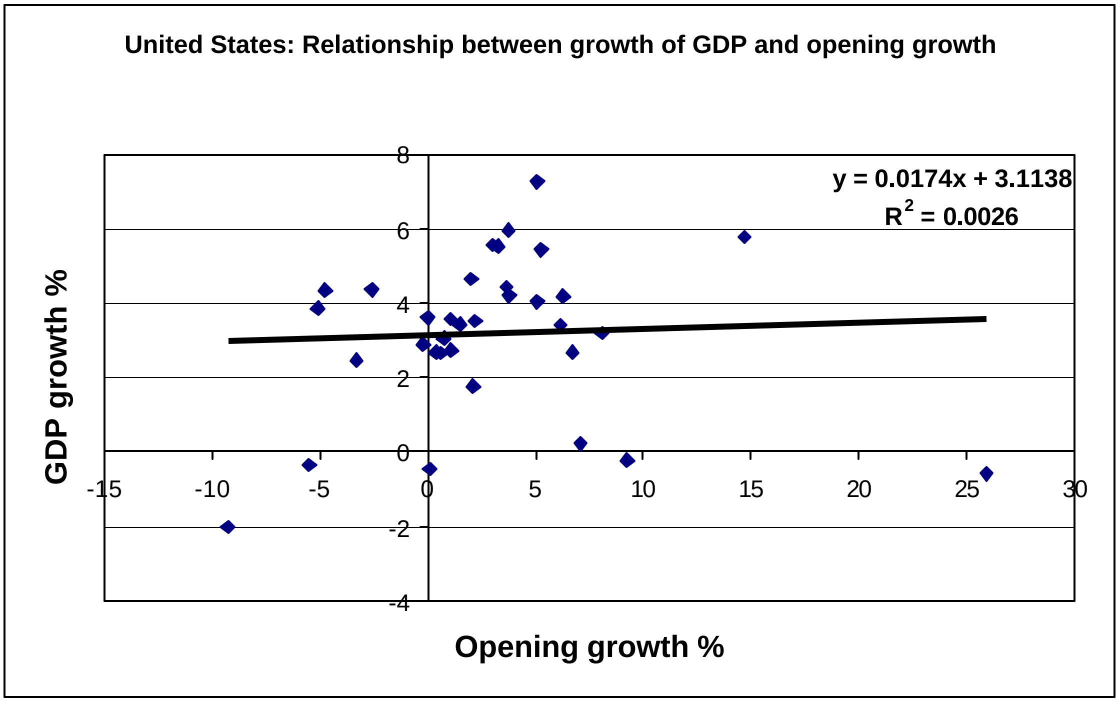
APPENDIX
GRAPH 1



APPENDIX
GRAPH 2



STATISTICAL DATA APPENDIX

- Per capita income of Mexico, Canada and the United States 1965-2000.
- World Bank's rate of growth for Mexico, Canada and the United States 1965-2000.
- Governmental expenditures of the three countries as percentage of GDP.
- FBCF/GDP of the three countries.
- Opening rate: Correlation between exports plus imports divided into the product.
- Population rates of growth.
- Per capita income logarithm in 1960, of the countries.
- Inflation rate, of the three countries, consumer price index.

End Notes

[i] The authors are Hall y Jones(1999), Sachs y Warner(1995), Dollar y Kraay (2001), Alcalá y Gicoone (2001). Besides the opening effects, Hall and Jones have come up with a social infrastructure index, which refers to governmental management in the presence of corruption, expropriation risks , etc., as well as data concerning to territorial extension of common language, distance to the Equator, the GDP international share of the international market, demographic and geopolitical characteristics. There is a positive correlation between this index and per capita GDP logarithm.

[ii] The external rate of GDP is calculated as follows: [(Exports + Imports) / GDP]. It has been suggested that the external rate of GDP is a good and impartial measure for the opening. (Sheeby, 1992; Easterly et al 2001; Berg and Krueger 2003; Dollar et al 1995).

[iii] Just like Dollar and Kray (2001), and because the variables are measured in rates of growth, it is not necessary to test unitary roots and co-integration. In Arora & Vamvakidis(2001), per capita GDP in the first year is the approximation of convergence, which is part of a set of explanatory variables: population growth, fixed capital investment, inflation, government consume, international trade share in GDP.

[iv] The signs of governmental investment and consume coefficients are equal to those found by Arora & Vamvakidis (2001). When using Dollar's direct foreign investment (1992) we found that this foretells the growth in the very same way that it does with the opening degree. Both variables are correlated.

[v] This non significant result is a part of a debate over de causation between economic growth and commercial opening. In relation to the hypothesis of trade opening as a source of economic growth and convergence, see: Ventura (1997), Grossman & Helpman (1991), Edwards (1998), Frankel & Romer(1998), Lucas (1988), Young(1991), Barro & Sala-i-Martin (1995), Dollar(1992), Sachs and Warner(1995), Ben-David(1993). Neither Slaughter (2001) nor Rodríguez & Rodrik (1999) found evidence showing that trade liberalisation has positive effects on countries' speed of convergence.

Causal Analyses between Foreign Trade and Economic Growth in China

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Abstract

This paper uses cointegration and error-correction model to analyze the causal relationship between foreign trade and economic growth in China using annual data from 1978-2001.The empirical results show evidence for unidirectional causality running from export growth to economic growth. There is also evidence that bi-directional causality exits between import growth and economic growth, and export growth significantly causes economic growth.

1. Introduction

The relationship between foreign trade and economic growth has long been a subject of much interest. The economists of Classical theories and endogenous economic growth theories demonstrate from different aspects that foreign trade is a positive-sum game and a driving force of economic growth. Foreign trade makes for a better allocation of resources and a greater utilization of the productive capacity; makes it possible to obtain economies of scale, resulting in the direct proceeds for countries involving in foreign trade; allows access to a wider base of technological knowledge; makes technological diffusion easier; motivates research and avoids redundancies; all these will accelerate the long-run growth of economy. These theories provide import academic foundation for expanding foreign trade.

Some development economists (Singer, 1950; Prebisch, 1962) argue that foreign trade brings on negative consequence in the long run for the Less Developed Countries. The Less Developed Countries specialize in products with low demand income elasticity for foreign trade. Therefore, with a weak perspective of exports growth, their trade terms have a tendency to constant deterioration. Furthermore, this specialization entailed significant economic and social costs of adaptation to the evolution of the chain of foreign trade. Some countries put into practice the introverted and protectionism development strategies in response to the protectionism trade policy reasoned by development economists after World War II.

Owing to the failure of introverted growth experiments and to the association of quick economic growth with the opening of foreign trade and the consequent international specialization in several countries, empirical pursuers have exhibited increased interest in undertaking the research on trade and growth to find sources of growth from the 1970's on. These studies focused on the export-led growth hypothesis can be categorized into two groups: those based on cross-country data and those based on time series data.

Early researches employ cross-country data to investigate the role of exports on economic growth through regressing real growth on contemporaneous real export growth. They generally conclud that highly significant positive correlation exists between export growth and economic growth, supporting for export-led growth hypothesis (See, for example, Michaely,1977; Balassa,1978; Tyler,1981; Feder,1983; Kavoussi,1984; Balassa,1985; Moschos,1989).There are some main weaknesses of these studies. Cross-country studies assume a convergent economic structure and similar production technology. These rigorous assumptions are most likely not true in reality. On the other hand, the researches suppose that export growth causes economic growth without considering the causal direction between the variable. In fact, while export growth speeds economic growth, aggregate economic growth resulting in scale economy can enhance the competitive advantage of export section and then promote export expansion. Simple correlation analysis cannot reveal the relationship adequately.

Time series analyses based on causality concept have been taken in a number of recent studies followed the pioneering study of Jung and Marshall,1985; (See, for example, Chow,1987;Darratt, 1987; Kunst and Marin, 1989; Salvatore and Hatcher, 1991; Ghartey,1993; Sengupta and Espana, 1994). The causality testing approach is designed to assess whether or not causality relationship exists between exports and economic growth and the causality direction if there is such relationship. The conclusions of these studies are different from those in cross-country data analyses. Some researches cast doubt on validity of export-led growth hypothesis (see, for example, Jung and Marshall, 1985; Darratt, 1987; Kunst and Marin, 1989; Ghartey, 1993). It should be pointed out that most macroeconomic variables are not stationary. In order to avoid the spurious regression problem that arises when statistical inferences are drawn from non-stationary time series, the time series properties of the data have to be investigated before employing causality test.

Testing for causality in multiple time series has been the subject of considerable recent researches. Vector autoregressive (VAR) model was applied in some of the researches (see, for example, Kunst and Marin, 1989; Jin, 1995; Jin and Yu, 1996; Jordan Shan and Fiona Sun,1998). VAR model need not to distinguish between exogenous variables and endogenous variables. Therefore it can avoid some specification bias of model. Whereas, no matter whether or not the variables are stationary, this unrestricted VAR system cannot abstain from over-parameter and multicollinearity problems that prevalently exit in multiple regression. Besides, these studies use F-test for Granger causality, but standard tests (such as t-test, F-test, Wald test) for causality originally designed for stationary variables are not valid if there exists cointegration (Granger, 1988). Engle and Granger (1987) provide a more comprehensive procedure for causality test for variables that are found to be cointegrated. This procedure is known as 'error-correction model' (ECM). ECM has many advantages. First of all, the variables involved in the ECM have the stationary property, ensuring the validity of causality test. Next, ECM has solved the spurious regression problem that puzzled econometrician for a long time. Furthermore, ECM compartmentalizes parameters of model into long-run parameters and short-run parameters, incorporates information from the cointegrated properties of time series and allows for a causal linkage between two (or more) variables stemming from an cointegrated relationship, consequently changing the complexion that previous empirical researches economic theory only discuss the causal linkage from the short-run adjustment of individual variables. Engle and Granger (1987) have proved that ECM is a restricted VAR model under cointegration restriction. This restriction has dealt with the over-parameter and multicollinearity system problems generally occurred in unrestricted VAR model.

Since the open door policy in 1978, China, the largest developing country in the world, has undergone far-ranging reforms of trade system that have steadily reduced the role of planning and increased the importance of market forces. This condition is likely to influence the relationship between foreign trade and economic growth. Several empirical studies have been undertaken to investigate the relationship between exports and economic growth in the case of China. These include, among others, Kwan and Cotsomitis (1991), Lee (1994), Zuo (1994), Xue (1995), Jordan Shan and Fiona Sun,1998; Shuanglin Lin(2000). They find that export growth has a positive impact on Chinese economic growth. However, except Jordan Shan and Fiona Sun,1998, they have not considered the properties of the original time series and consequently their inferences may suffer from the spurious regression problem. Zuo (1994), Lee (1994), Xue (1995), Shuanglin Lin(2000) make a assumption that export growth causes economic growth and do not consider the direction of the causal relation. Kwan and Cotsomitis (1991) have based their studies on a simple two-variable framework in the causality, while a simple two-variable framework may be subject to a possible specification bias. Jordan Shan and Fiona Sun,1998 have applied a six-variable VAR system to test the causality link between exports and economic growth. This unrestricted VAR system may suffer from serious over-parameter and multicollinearity problems that prevalently exit in multiple regressions.

The focus of the paper is to test the causal relationship between foreign trade and economic growth in China for the period from 1978-2001.This paper examines the direction of causality between foreign trade and economic growth by utilizing a cointegration and error-correction modeling framework, which provides a more comprehensive test of causality than the standard Granger causality test.

The remainder of this paper is organized as follows. Section II sketches the econometric model employed in this paper. Section III uses unit roots test to examine properties of the univariate time series. Given the nonstationarity nature to each of the univariate series, cointegration analysis is employed. The evidence supports for cointegration relationship among variables, so causality relationship is examined through error-correction model. Section IV provides conclusions. All operations are finished by EVIEWS3.1.

2. Econometric methodology and data

To undertake the analysis, this paper uses Chinese annual time series data over the period 1978-2001. The economic growth is measured by GDP, and the trade growth is denoted by export growth and import growth. All annual data are collected in logarithm and deflated using CPI index, for GDP (LPGD), exports (LPEX) and imports (LPIM). The data source is China Statistical Yearbook published by China Statistical Bureau.

In this paper, the relationship between trade and economic is empirically tested for Granger causality with error-correction model. Since it is essential to check for the cointegrating properties of the original real exports, imports and GDP series before applying the standard Granger test, cointegration analysis is applied first. Granger(1986) and Engle and Granger(1987) define a nonstationary time series X_t to be integrated of order d , $I(d)$, if it achieves stationary after being differenced d times. For $d ? 0$, X_t is stationary in levels and no differencing is necessary. If the time-series variables are found to be nonstationary and integrated of the same order, tests can be performed to see if the variables are cointegrated. An identified cointegrating relationship among variables implies there exists a long-term equilibriating relationship among those variables. Generally, a set of variables are side to be cointegrated of a linear combination of their individual integrated series, which are $I(d)$, a regression is run, such as:

$$Y_t ? ?X_t ? ?_t \quad (1)$$

If the residuals ($?_t$) from the regression are $I(0)$, then X_t and Y_t are said to be cointegrated. The constant and trend values can be included in equation (1) as needed.

The main methods for cointegration analysis are Engle-Granger(1987) cointegration analysis and multivariate maximum likelihood testing procedure (Johansen ,1988; Johansen and Juselius,1990; Johansen,1995). Engle-Granger (1987) cointegration analysis assumes uniqueness of the cointegrating vector. However, in a multivariate context, the number of cointegrating vectors could be more than one. Furthermore, Engle-Granger mothod cannot make sensible judgement about the significance of the parameters on account of non-normality of the distribution of the estimators of the cointegrating vector. Johansen (1988), Johansen and Juselius (1990) and Johansen (1995) have developed a multivariate maximum likelihood testing procedure on the number of cointegrating vectors that also includes testing procedures for linear restriction on the cointegrating parameters. In this paper, multivariate maximum likelihood testing procedure is used to make judgements.

In order to determine the integration level and the possible cointegration among variables, this paper employs the Augmented Dickey-Fuller(ADF hereafter) test which is based on estimating the following regression:

$$?X_t ? ?_0 ? ?_1 t ? ?_2 X_{t?1} ? \overset{k}{\underset{i?1}{?}} c_i ?X_{t?i} ? ?_i \quad (2)$$

Where $?X_t ? X_t ? X_{t?1}$ and X is the variable under consideration, k is the number of lags in the dependent variable, $?_t$ is the stochastic error term. The null hypothesis is $H_0 : ?_2 ? 0$. If the null hypothesis cannot be rejected, it implies that the time series is nonstationary at the level and therefore it requires taking first or higher order differencing of the level data to establish stationarity. The optimum lag length k is selected using the Akaike Information Criterion (AIC) and Schwarz Criterion (SC).

Granger(1969) has brought forward a test of causation, a variable X is said to cause another variable Y , concerning a given information set that includes X and Y , if current Y can be predicted better by using past values of X than by not doing so, given that all other past information in the information set is used. In view of the properties of time series, Engle and Granger(1987) provide a more comprehensive procedure for causality test for variables that are found to be cointegrated. They have shown that if variables are integrated of order one, that is $I(1)$, and are cointegrated then either unidirectional or bi-directional Granger causality must exist in at least the

$I(0)$ variables. If the variables are cointegrated, there must exist an error-correction representation. A vector ECM can be established as follows:

$$? LPGD_t \; ? \; \mathop{?}\limits_{i?1}^{k} \; ?? _{1i} ? LPGD_{t?i} \; ? \; ?_{1i} ? LPEX_{t?i} \; ? \; ?_{1i} ? LPIM_{t?i} ?? \; ?_1 EC_{t?1} \; ? \; ?_1 \quad \text{(3a)}$$

$$? LPEX_t \; ? \; \mathop{?}\limits_{i?1}^{k} \; ?? _{2i} ? LPGD_{t?i} \; ? \; ?_{2i} ? LPEX_{t?i} \; ? \; ?_{2i} ? LPIM_{t?i} ?? \; ?_2 EC_{t?1} \; ? \; ?_2 \quad \text{(3b)}$$

$$? LPIM_t \; ? \; \mathop{?}\limits_{i?1}^{k} \; ?? _{3i} ? LPGD_{t?i} \; ? \; ?_{3i} ? LPEX_{t?i} \; ? \; ?_{3i} ? LPIM_{t?i} ?? \; ?_3 EC_{t?1} \; ? \; ?_3 \quad \text{(3c)}$$

Where $EC^{i?1}_{t?1}$ is the error-correction term obtained from the cointegrating regression equation, ? represents first-differences. If the series are cointegrated, then the error-correction models are valid and the coefficients $?_1$, $?_2$ and $?_3$ are expected to capture the adjustments of $?LPGD_t$, $?LPEX_t$ and $?LPIM_t$ towards long-run equilibrium. $?_{1i}, ?_{1i}, ?_{1i}$ are coefficients that describe the effects of k current and past values of $?LPGD_t$, $?LPEX_t$ and $?LPIM_t$ on $?LPGD_t$ respectively in equation (3a), $?_{2i}, ?_{2i}, ?_{2i}$ describe the effects of k current and past values of $?LPGD_t$, $?LPEX_t$ and $?LPIM_t$ on $?LPEX_t$ respectively in equation (3b), $?_{3i}, ?_{3i}, ?_{3i}$ describe the effects of k current and past values of $?LPGD_t$, $?LPEX_t$ and $?LPIM_t$ on $?LPIM_t$ respectively in equation (3c). The $?_1, ?_2$ and $?_3$ are mutually uncorrelated white noise series.

The Granger causality can be tested through the null hypotheses that $?_{1i} \; ? \; 0, ?_{1i} \; ? \; 0$ in equation (3a) , $?_{2i} \; ? \; 0, ?_{2i} \; ? \; 0$ in equation (3b) and $?_{3i} \; ? \; 0, ?_{3i} \; ? \; 0$ in equation (3c) for all i respectively, which can be done using standard tests. If null hypotheses are accepted, then there is no causality. If some $?_{1i} \; ? \; 0$ or some $?_{1i} \; ? \; 0$, for instance, focusing on equation (3a), then $?LPGD_t$ is said to be caused by $?LPEX_t$ or $?LPIM_t$. If both $?_{1i} \; ? \; 0$ in equation (3a) and $?_{2i} \; ? \; 0$ in equation (3b), then there is bi-directional causality between $?LPGD_t$ and $?LPEX_t$. The relationship between other variables such as $?LPGD_t$ and $?LPIM_t$, $?LPEX_t$ and $?LPIM_t$ can be determined in light of the same way.

The inclusion of $EC_{t?1}$ in the Error-correction model gives an extra channel through which the effects of causality can occur. It incorporates information from the cointegrated properties of time series and allows for—in addition to the causal linkage from the short-rum adjustment of individual variables—a causal linkage among variables stemming from a cointegrated relationship. The long-run relationship among variables can be tested on the null hypotheses that $?_1 \; ? \; 0$ in equation (3a), $?_2 \; ? \; 0$ in equation (3b) and $?_3 \; ? \; 0$ in equation (3c). If the null hypotheses cannot be rejected, there is no causality from $EC_{t?1}$, if the null hypothesis is rejected, causality is inferred.

For the sake of avoiding arbitrary lag-length k specification, a statistical procedure is used for choosing the lag length.

3. Empirical results

Test results for unit root

Each time series are first tested for their orders of integration by using ADF test (Table 1). The tests show that

LPGD, LPEX and LPIM achieve stationarity after being differenced one time, so they are integrated of order one, or $I(1)$, at the 5% level of significance.

TABLE 1. ADF TEST RESULTS FOR UNIT ROOTS

Variables	ADF	Critical Values (5%)	Lag	Conclusions
LPGD	-3.630362(a)	-3.6920	5	Nonstationary
LPEX	-1.926379(a)	-3.6330	1	Nonstationary
LPIM	-2.484682(a)	-3.6330	1	Nonstationary
? LPGD	-3.309674(b)	-3.0114	1	Stationary
? LPIM	-3.395153(b)	-3.0114	1	Stationary
? LPEX	-4.776046(b)	-3.0114	1	Stationary

Note: (1) The critical values for the ADF tests are taken from EVIEWS3.1 ; (2) The optimum lag length is selected using the AIC and SC;(a) The ADF test includes constant and trend; (b) The ADF test includes constant but no trend.

Test results for cointegration

Since the time series of LPGD, LPEX and LPIM are found to be integrated of the same order (i.e, order one), a cointegration test can be conducted to determine whether a long-run equilibriating relationship exists between them. Johanson multivariate maximum likelihood testing procedure is performed.

Before applying cointegration test, this paper determines the structure of Vector Autoregressive (VAR) Models first because Johanson cointegration test is a method based on VAR Models. To determine the order of VAR used in Johanson cointegration test, the order of a unrestricted VAR should be confirmed first. This paper has therefore built the following three-variable unrestricted VAR(k) system:

$$\begin{bmatrix} LPGD \\ LPEX \\ LPIM \end{bmatrix}_t ? ?_1 \begin{bmatrix} LPGD \\ LPEX \\ LPIM \end{bmatrix}_{t?1} ? ?_2 \begin{bmatrix} LPGD \\ LPEX \\ LPIM \end{bmatrix}_{t?2} ? \ldots ? ?_k \begin{bmatrix} LPGD \\ LPEX \\ LPIM \end{bmatrix}_{t?k} ? C ? ?_t$$

$$t ? 1,2,\ldots,T \quad (4)$$

where $?_1, ?_2, \ldots, ?_p$ are coefficient matrix, C is intercept vector, $?_t$ is error term, k is the order of VAR system.

With a view to balancing between ensuring approximately white-noise errors and allowing for enough degrees of freedom in estimation, the optimum VAR order is estimated from 3 to 1 in turn with the AIC and SC, and confirmed by LR tests. The results show that the VAR order is optimum when it is 3 according to the AIC while it is 1 by the SC. LR test is used to determine the optimum VAR order between lag length 1 and lag length 3. The LR test null hypothesis H_0 : k=1,

$$LR ? ?2*(l_1 ? l_3) ? ?2*(87.6035 ? 101.9032) ? 28.5994$$

where l_1 and l_3 denote the log likelihood value when VAR order k is 1 and 3, respectively ; $LR \sim\ ?^2(18)$.

The result rejects the null hypothesis at significance level of 5.35% , so the optimum unrestricted VAR order is 3.

Because Johanson cointegration test is applied to VAR Models under cointegration restriction, the order of the restricted VAR system is the lag length of first differencing variables in unrestricted VAR system. Accordingly, VAR(2) system for Johanson cointegration test is used to determine the number of cointegration equation (r), based on eigenvalues of the stochastic matrix.

The result of Johanson cointegration test (Table 2) indicates that one can reject the null $r\ ?\ 0$ against the alternative $r\ ?\ 1$, but cannot reject the null $r\ ?\ 1$ against the alternative $r\ ?\ 2$, that is, there exists a 'unique' cointegrating equation among LPGD, LPEX and LPIM at 5% significance level.

TABLE 2. RESULT OF JOHANSON COINTEGRATION TEST

Eigenvalue	Likelihood Ratio	Critical Value at 5%	Critical Value at 1%	Null hypothesis No. of CE(s)	Alternative hypothesis No. of CE(s)
0.699995	44.60768	34.91	41.07	r=0 **	r=1
0.434188	19.32459	19.96	24.60	r=1	r=2
0.295823	7.365222	9.24	12.97	r=2	r=3

Note: (1) *(**) denotes rejection of the hypothesis at 5%(1%) significance level.
L.R. test indicates 1 cointegrating equation(s) at 5% significance level.
(2) The length of the lag is estimated with AIC and SC.

The cointegrating equation is represented as follows:

$$EC\ ?\ LPGD\ ?\ \underset{(?6.35)}{0.8615}LPEX\ ?\ \underset{(2.62)}{0.3889}LPIM\ ?\ \underset{(?33.28)}{6.0199} \qquad (5)$$

Note: The number in parentheses represents t statistics.

The result of the ADF test applied to residual of the cointegration equation denotes the cointegrating equation is stationary at 5% significance level (Table 3), supporting that cointegration exists among the variable vectors.

TABLE 3. RESULT OF THE RESIDUAL-BASED ADF TEST FOR COINTEGRATION

ADF Test Statistic	5% Critical Value	10% Critical Value
-3.146120	-3.0038	-2.6417

Test results for causality

Having confirmed the existence of a 'unique' cointegragion relationship for real GDP, exports and imports over the long run, this paper conducts Granger causality test in the context of a vector ECM by estimating a restricted VAR model under cointegration restriction to determine whether the causality relationship exists among the data series. Because vector ECM is a restricted VAR model under cointegration restriction, the optimum order of the unrestricted VAR system determined is 3, so a VAR(2) system is used for vector ECM. Various mis-specification tests of the VECM are reported in Table 4. No problem is revealed at 5% significance level in these tests, the validity of the system can therefore be taken with confidence.

TABLE 4. PROPERTIES OF VECTOR ECM RESIDUALS

	?LPGD	?LPEX	?LPIM
White statistics	0.9841	1.5450	0.3788
P value	0.55	0.31	0.94
ARCH(1) LM statistics	0.3295	1.9704	0.5471
P value	0.57	0.16	0.46
ARCH(2) LM statistics	0.5839	2.2484	4.9743
P value	0.75	0.32	0.08
JB Normality statistics	2.0713	0.6574	0.7679
P value	0.35	0.72	0.68

Note: ? represents first-differences.

The empirical results of causality test on the estimated vector ECM are presented in Table 5.

TABLE 5. CAUSALITY TEST BASES ON VECM

$$?LPGD_t ? \underset{i?1}{\overset{2}{?}} ?? _{1i} ?LPGD_{t?i} ? ?_{1i} ?LPEX_{t?i} ? ?_{1i} ?LPIM_{t?i} ?? ?_1 EC_{t?1} ? ?_1 \quad \text{(6a)}$$

	Test for $? \; ?_{1i} ?LPEX$	Test for $? \; ?_{1i} ?LPIM$	Joint test	Test for $EC_{t?1}$
H_0	$?_{1i} ? 0, ? i$	$?_{1i} ? 0, ? i$	$?_{1i} ? ?_{1i} ? 0, ? i$	$?_1 ? 0$
Wald Statistics	7.189492	5.640480	3.653262	28.80221
P -value	0.007111	0.015971	0.030714	0.000099

$$?LPEX_t ? \underset{i?1}{\overset{2}{?}} ?? _{2i} ?LPGD_{t?i} ? ?_{2i} ?LPEX_{t?i} ? ?_{2i} ?LPIM_{t?i} ?? ?_2 EC_{t?1} ? ?_2 \quad \text{(6b)}$$

	Test for $? \; ?_{1i} ?LPGD$	Test for $? \; ?_{1i} ?LPIM$	Joint test	Test for $EC_{t?1}$
H_0	$?_{2i} ? 0, ? i$	$?_{2i} ? 0, ?_i$	$?_{2i} ? ?_{2i} ? 0, ? i$	$?_2 ? 0$
Wald Statistics	0.140891	2.915549	3.669299	7.891816
P -value	0.869800	0.087391	0.030287	0.013925

$$?LPIM_t ? \underset{i?1}{\overset{2}{?}} ?? _{3i} ?LPGD_{t?i} ? ?_{3i} ?LPEX_{t?i} ? ?_{3i} ?LPIM_{t?i} ?? ?_3 EC_{t?1} ? ?_3 \quad \text{(6c)}$$

	Test for $? \; ?_{1i} ?LPGD$	Test for $? \; ?_{1i} ?LPEX$	Joint test	Test for $EC_{t?1}$
H_0	$?_{3i} ? 0, ? i$	$?_{3i} ? 0, ? i$	$?_{3i} ? ?_{3i} ? 0, ? i$	$?_3 ? 0$
Wald Statistics	3.588567	2.404312	3.146996	2.389850
P -value	0.055186	0.126589	0.048416	0.144426

Note: $EC_{t?1}$ is equivalent to EC in equation (5).

The error-correction term $EC_{t?1}$ represents the long-run impact of variables on other variable. Statically significant non-zero $?_1$ and $?_2$ suggest that in the long-run real trade growth (including real export growth and import growth) Granger causes real GDP growth at 0.01% significance level, and real imports and GDP growth Granger cause real exports growth at 1.4% significance level.

Turning to the short-run Granger causality, the results indicate that unidirectional causalities exist from real export growth to real GDP growth at 0.8% significance level and from real import growth to real export growth at 8.8% significance level. Bi-directional causality exists between real GDP growth and real import growth, while the causality from real import growth to real GDP growth (with the 1.6% significance level) is stronger than the causality from real GDP growth to real import growth (with the 5.6% significance level). Moreover, results of joint test show that in the short run real trade growth (including real export growth and import growth) Granger causes real GDP growth at 3.1% significance level; real import and GDP growth Granger cause real export growth at 3.1% significance level; real GDP and export growth Granger cause real import growth at 4.9% significance level.

It is important to note that negative signs for the corresponding error-correction terms (Table 6) accord with the reverse modification mechanism of ECM. The estimated parameters on $?_1$, $?_2$ and $?_3$ give an indication of how fast $?LPGD_t$ and $?LPEX_t$ adjust themselves toward the long-run equilibrium level. For $?LPGD_t$, the adjustment was made at a speed of around 2.8 years (a coefficient of around 0.36 on annual data). For $?LPEX_t$, the adjustment was about one year (a coefficient of around 1.04 on annual data).

Table 6. Coefficient for $EC_{t?1}$ from vector ECM

Error Correction:	$?LPGD$	$?LPEX$	$?LPIM$
Coefficient for $EC_{t?1}$	-0.358579	-1.039937	-0.551153
t-statistic for $EC_{t?1}$	(-5.36677)	(-2.80924)	(-1.54591)

4. Conclusions

This paper has analyzed China annual data for real GDP, exports and imports over the period 1978-2001. The empirical results indicate that level data series are integrated of order one and a 'unique' long-run equilibrating relationship exits among the data series, namely, the series are cointegrated. In order to avoid multicollinearity and simultaneity bias problems, a VECM system is applied to investigate the causality relationship among these cointegrated time series. The causality test by estimated VECM reveals a bi-directional causality between the growth of foreign trade and real GDP not only in the short run but also in the long run. It can be maintained that trade expansion and economic growth are two interactive processes of economic development. In addition, this study has also investigated the effects of export growth and import growth on GDP growth in China respectively. It has been shown that export growth significantly causes economic growth, and bi-directional causality exists between import growth and GDP growth while the causality from import growth to GDP growth is stronger. The Chinese experience confirms that trade expansion play an important role in accelerating economic growth. These findings are virtually consistent with the theoretical hypothesis presented by classical economic theories and endogenous economic growth theories.

Reference

Contact the author for a list of references.

The Open Chinese Capital Account:
Principles, Prerequisites and Procedures

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Abstract

The most important issue of an economy is to allocate resources efficiently. The efficiency of the capital market is critical in the process of converting residents' savings into investments. To open a nation's capital market to the outside world means that the restrictions on the types of financial services are provided by different financial institutions will be removed and the restrictions on cash flows will be removed. An open capital market will benefit the growth of the economy. It could also induce unexpected risks and even financial crises.

This paper will investigate the relationship between capital liquidity and economic growth, analyze Chinese capital market efficiency under the framework of WTO, and suggest suitable solutions to enhance Chinese capital market efficiency. It will discuss the potential problems and risks of an open capital market and the suitable policy reactions in a more volatile financial environment.

I. Introduction

The increasing volatility of financial market is one of the main economic phenomena of the past quarter century. Since the World War II, the world economy has been integrated to such a degree that not only end products are traded globally, but production factors, such as capitals, materials and production equipment, are moving around the world also. The new global economic environment posts great challenges to not only corporations that are operating internationally, but also governments that are striving to enhance the political and economic competitiveness of their countries. Although volatile financial market may increase business risk, they also create profitable investment opportunities for both firms and investors, given a proper understanding of financial risk management. In the process of economic globalization, the integration of financial markets is one of the most difficult issues. Government officials, industry leaders and financial experts have been discussing the issue of opening capital account intensively for a number of years. As a matter of fact, it is one of the most difficult, most controversial and most risky problems in the economic globalization process for the developing countries. The pros and cons of opening capital account are so ambiguous that the decision makers may often do things right in one aspect but do things wrongly in others.

If we look at the recent financial crises around the world, it is not difficult at all to find out how risky to open a country's capital account to the outside word is. The Latin America countries' crises in the 1970s and 1980s, the Mexico crisis in 1994 and the Southeast Asia crisis in 1997 are all related with the improper opening of the capital account in someway. Although this inductive reasoning may not be totally reliable due to the small size of the sample, it would be beneficial for us to fully consider the potential financial, economic and even political uncertainties imbedded in the opening process of Chinese capital account. There are several important questions we need to consider before we go further to the next step of China's financial system reform. Is it necessary for a country, say as large as China to open its capital account? If yes, how to open the capital account properly? What is the right procedure to open the capital account? How to maximize the benefit of globalization while avoiding the unexpected financial risk and crisis? These are important issues that the decision makers of developing countries are facing when considering to open the capital account.

Let's take a brief look at the latest history of the development of China's financial market. Since the seventies of last century, China's financial system reform has roughly fallen into the following three phases:

(1) The first phase started from 1978 and ended in 1996, which was the initial formation period of Chinese financial system.
(2) The second phase started from 1996 and ended in 2001, which was the reform period of Chinese financial system.

(3) The third phase started from 2001 and lasted till present, which is the period of opening Chinese financial market according to the WTO agreement.

At present, how and when to open of Chinese capital account draws significant attention from financial practitioners, government officials and theorists all over the world. This is probably because that the scope and the procedure of the open of Chinese capital account will have significant impact not only on the direct returns of the investors both inside and outside China, but also on the way of participating and managing their financial risks in the long run for the major financial market players.

The timing of opining China's capital account is the crucial part of the decision. If China's capital account opens too early, it will induce the expected risks for Chinese financial institutions and investors. The ill-prepared opening may put them into unfavorable competitive positions of the market. On the other hand, however, if Chinese capital account opens too late, it will undermine the development of Chinese financial market and impair the competitiveness of Chinese financial institutions even further. Therefore, the issue of open Chinese capital account constitutes a real dilemma for Chinese decision makers.

Let's analyze the issue a little bit further by looking at the underlying forces of the opening capital account. Based on the fundamental methodology of the economic analysis, there are two underlying forces determining the openness of the capital account. One underlying force is the demand for capital market efficiency; the other one is the desire for financial stability. The conceptual relationship between the market efficiency and the degree of capital market openness is that the more the capital market openness, the larger the capital market efficiency. On the other hand, the conceptual relationship between the financial market stability and the openness of the capital market is that the more the capital market openness, the less the financial stability. The art to deal with the open of capital account needs a well-designed combination of these two underlying forces. Fig. 1 depicts these conceptual relationships in the following page.

The goal of open capital account is to increase the liquidity of the capital asset so that the resources can be allocated more efficiently. As a matter of fact, to open capital account is an important step to enhance the efficiency of the capital market. An efficient capital market allows the transfer of financial assets with little loss of wealth. Capital market efficiency results from market prices reflecting all available information so that prices are fair to all market participants. But how can prices in the capital market reflect all available information?

It is generally believed that an efficient market should posses the following features.

(1) There are no barriers to entry in the financial market. This is one of the key aspects of perfect market competition.
(2) The market competition is perfect, which means all participants in the financial market are price-takers.
(3) Financial assets are infinitely divisible. This will enable the buyers and sellers to trade any amount of the financial asset they agree upon.
(4) No transaction costs, no bankruptcy costs. This feature will make the law of value additivity hold in the financial market. Value additivity means that the value of the whole exactly equals the sum of the values of the parts. If value additivity holds, the law of value conservation holds.
(5) All existing information is fully available without charge. This feature will make it possible for all market participants obtain the information instantly.
(6) No government or other restrictions on financial assets trading. This will allow the financial market participants to take any position they want, no matter long position or short position. In other words, there is no penalty to take short position.
(7) Market participants are rational in making their financial decisions. This feature means that all the investors are so knowledgeable that they can understand and interpret the market information properly and take correct actions based on the newly receiving the information.

The above features are the assumptions of the Efficient Market Hypothesis (EMH). If we compare these assumptions of EMH with the financial market in the real world, we find that these conditions are not fulfilled in the real financial market. Usually, there is a big gap between the two. But the assumptions of EMH have extremely important implications for us to improve the efficiency of the capital market. These assumptions could serve at least as the guidelines to improve the efficiency of the capital market.

Capital asset's liquidity plays an important role in an efficient market. The more liquid the capital assets are, the more efficient the capital market. Money allows for the easy transfer of resources, much as liquids can flow through a tube better than solids. The rate at which a liquid flows depends on how thick the liquid is. Therefore, to improve capital market's liquidity becomes one of the key approaches to enhance economic growth of a nation.

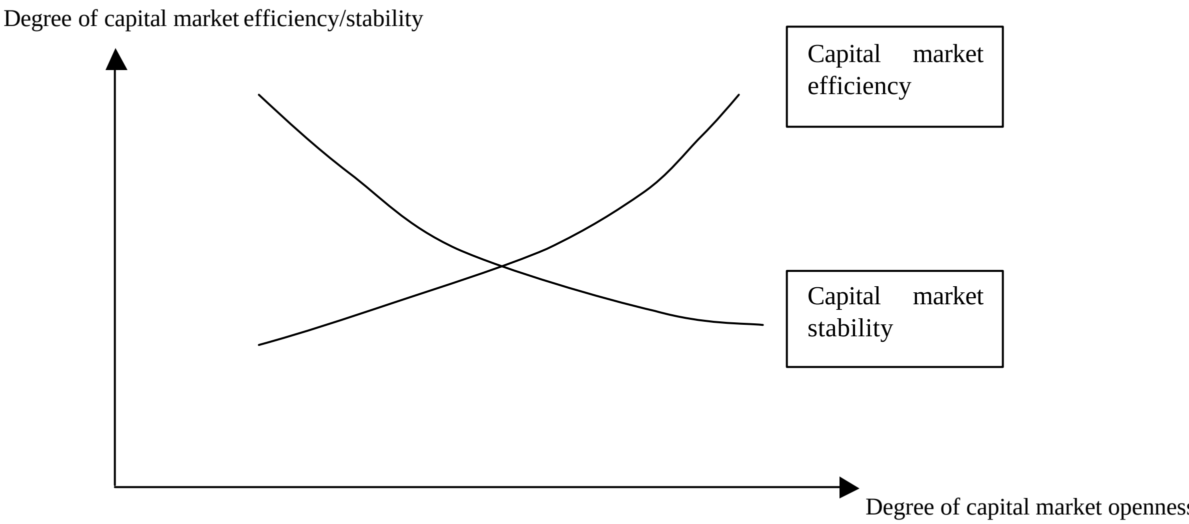

Fig.1: RELATIONSHIPS AMONG CAPITAL MARKET EFFICIENCY, STABILITY AND DEGREE OF CAPITAL MARKET OPENNESS

For several centuries, economists have used the classical economic theory of comparative advantage to explain trade movements between nations. Springing from the writings of Adam Smith and David Ricardo in the eighteenth and nineteenth centuries, the theory, in simple terms, states that everyone gains if each nation specializes in the production of those goods that it produces relatively most efficiently and imports those goods that other countries produce relatively most efficiently. In other words, every country, small or large, in the world will benefit from international trade as long as it produces goods according to its comparative advantage. Up till now, the world economy has internationalized, globalized, multinationally integrated, whether individuals in specific countries or specific forms recognize or acknowledge it. As firms expand their sales of products and services, their input sourcing, their management structures, their very profits across borders, the problems of financial management become more important and more complex. Nowadays, Chinese government is undertaking the policy of sustainable economic growth, which is one of the fundamental and far-reaching economic policies. To achieve this objective, Chinese government needs to set its economic goals compatible with the goal of the conservation of the natural environment in the long run. To enhance the capital market efficiency is definitely one of the important subsets of the sustainable growth policy. To achieve this objective, it is necessary to remove or eliminate capital market imperfections, which include transactions cost, information asymmetry and government tax. There is no doubt that to open Chinese capital account is in the line of the world trend of globalization.

The subsequent issues in dealing with the opening capital account are:

(1) What are the fundamental principles of opening Chinese capital account?
(2) What are the major contents of the open of Chinese capital account?
(3) What is the appropriate procedure of open Chinese Capital account?

This paper will focus on the solutions of these questions. Nevertheless, the aim of this paper is not to depict a clear picture of the path of the open of Chinese capital account will probably follow in the next ten or twenty years, but rather to provide some basic ideas and clues to start with this significant program. Moreover, I would like to stress that the decision making of the opening of Chinese capital account should be a dynamic continuum. The right way to deal with this issue is to incorporate new information into the decision-making system whenever possible and react to that information properly. The flexibility to react to the new environment is of great value, especially in dealing with such an important issue. Before we move on to discuss these important issues, let's take a look at the practice of the open of Chinese capital account.

II. An Overview of the Practice of the Opening Process of Chinese Capital Account

China is the biggest developing country in the world. The fast growing of China's economy makes it one of the driving forces for the world economy in recent years. The growth of Chinese economy has significant impact on the world economy as a whole and the Asia countries surrounding China in particular. China's capital market is one of the largest emerging capital markets in the world. It provides higher-return investment opportunities for investors both inside and outside China. It is necessary to notice that Chinese economy is in its transition period from planned economy to market economy at the time being. A market economy with Chinese characteristics has been formed in the past twenty years. The capital market is by all means the core subset of the total market because of the close relationship existed between financial sectors and other industries. .

During this transition period, there are two basic objectives for Chinese government to pursue in controlling its capital account.

(1) To avoid domestic capital escape out of China. A well-known analogy is that the capital is the blood of the economy. This simple analogy illustrates the dominant role capital plays in economic growth of a country. Since capital escape may undermine the sustainable economic development, the central government needs to take actions to avoid capital escape from happening.

(2) To avoid massive speculative short-term capital inflow. The basic principle of finance tells us that there is a trade-off between risk and expected returns. If some investors obtain huge returns while taking little risk for the financial transaction, we would like to say that the financial market is not quite efficient. The arbitrage opportunity may result in unbalance of the domestic capital market. Therefore, the regulators need to make effort to eliminate the risk-free arbitrage opportunities and encourage long-term capital flows to Chinese capital market.

Next, let's review the capital account regulations of some of the major economies in the world. Table 1 provides us with some critical information about International Monetary Fund member countries' current account and capital flow supervision framework.

Table 1[i]: IMF MEMBER COUNTRIES CURRENT ACCOUNT AND CAPITAL FLOW SUPERVISION FRAMEWORK

Items	# of Countries	PRC	U.S.	U.K.	France	Germany	Japan
Open current account	150	·	·	·	·	·	·
Restrictions on capital account transaction							
Capital market security transaction	133	·	·				
Money market security transaction	115	·	·		·		
Collective investment security	103	·	·		·		
Derivatives and other securities	87	·					
Commercial credit	105	·					
Financial Credit	112	·					
	88	·					
Direct investment	149	·	·	·	·		·
Direct investment clearing transaction	52						
Real estate	134	·					
Individual capital flow	82	·					
Specific clauses on commercial bank and other credit institutions	155	·		·			·
Specific clauses on institutional investors	82	·			·	·	·

Based on the information provided by the table above, it is fairly easy for us to get the first impression that China has been put relatively strict restrictions on its capital account compared with other major economies. This conclusion makes sense because China has restrictions on 12 of the 13 items while U.S., U.K, France, Germany and Japan only have 4, 2,4,1and 3 items respectively. But wait a minute, we need to investigate the fact with more details before we draw our conclusion.

First of all, China's capital account restriction is not as strict as it seems to be. In practice, many items of Chinese capital account have been opened to a certain degree, even though they are restricted nominally. For example, in the 28 items under the capital account, China only puts relatively strict restrictions on 5 of them, which is 17.86% in 1999[ii]. These strict restricted items include cash outflow of the direct investment, residents' foreign equity investment, residents' foreign debt security investment, and residents' purchasing securities in foreign countries and residents borrowing of foreign securities.

Secondly, China has been put relatively loose restriction on 11 items of the capital account, which constitute 39.29% of the total. These loosely controlled items include foreign direct investment, residents' issuing equity in foreign countries, residents' returning principals of investment back to their foreign lenders, inflows of trade credits, etc.

Thirdly, China has been put almost no restriction on 12 items, 42.85 % of the total. Outflow of foreign direct investment, flow of non-residents equity investment (the B share), and cash inflow and some other items are fallen into this category.

Finally, statistical figures from the authority may provide us with additional message about Chinese capital account control. According to Mr. Dai Xianglong, the former president of the People's Bank of China, there are 43 items under the capital account according to the IMF classification, China realized convertible in 12 of them, which constitutes 28% of the total. China has only restrictions on 16 items, which is 37%of the total[iii].

Up till now, China has been making significant progress along the way of opening capital account. For example, a number of foreign financial institutions have established their business branches in the fastest growing areas in China, such as Beijing, Shanghai, and Shenzhen. The business scope of foreign financial institutions has been broadened significantly. Some foreign financial institutions have even been authorized to deal with Chinese RMB business. In the spring of the year 2003, QFII s (qualified foreign institutional investors) are allowed to purchase Chinese listing corporations' shares. In addition, the QDII (qualified domestic institutional investors) system is under consideration of Chinese financial decision makers at the time Being.

Based on the analysis above, it is reasonable to conclude that although China has restrictions for the capital account, it is not as strict as it seams to be. Moreover, China is making effort to open its capital account to a larger extend. An open Chinese capital market will benefit not only Chinese firms and investors, but world economic growth as well. The essence of the issue is how to avoid the unexpected risks in the process of opening Chinese capital account.

III. The Fundamental Principle of the Open of Chinese Capital Account

To open capital account is by all means a far-reaching decision in the process of a country moving from a closed economy towards an open society. To open capital account fully means a country's economy and financial market are integrated into international society to a larger extend. Chinese domestic corporations will have more opportunities to seek cheaper fund to finance their profitable investment projects. In addition, investors will have more chances to get a higher return because there will be more successful corporations playing in the capital market. On the other hand, however, open capital account also means there would be more chances for financial speculators and arbitragers to utilize market imperfections (transaction cost, information asymmetries and government tax, etc.) to get risk-free returns by taking advantage of the opportunities of mis-priced financial assets often appear in a newly freed financial market. The decision of whether or not to open the capital account is not only a strategic economic decision, but also a political decision. It will have immense impact on the future economic operation both in the short run and long run. To make a sound decision, the decision makers need to put this decision issue into a big picture of international relationships among various countries. The decision makers should not only have a good command of knowledge about economics, finance and politics, but also have a deep understanding of the evolution of international political in economic relationships and the their development trend. The fundamental question is to understand where we are at present and where we want to go in the future. The following points can be served as the basic guidelines when dealing with the issue of China's opening capital account. The fundamental principle is to strengthen Chinese economic power and contribute to the growth of the world economy. First of all, there are no mandatory clauses to open the capital account either in the IMF agreement or the WTO agreement. Therefore, when and how to open the capital account is totally depending on Chinese decision makers' own judgment. In other wards, China has the option to decide whether to open its capital account. Secondly, many developed countries open their capital accounts in and after the eighties of last century. Some immerging financial market opened their capital account even in the nineties of last century. In fact, some of them opened their capital account so hastily that they cannot control the rash cash flow risk properly and resulted in financial crises. Confucius once said: "Preparation ensures success. People can not expect success without proper preparation"[iv]. I personally have no doubt that we will benefit from the wisdom of ancient Chinese philosopher if we lesson to him carefully even in dealing with the modern affair as complex as capital account opening. One important fact is that China is not under the time pressure to open its capital account. China has enough time to make a sound decision on the open of its capital account. The bottom line of this issue is that it should enhance Chinese economic sovereignty. The criterion to judge whether it is a sound decision should be whether it would enhance the ability of Chinese government to control the financial market stability and improve its macroeconomic performance in the long run.

IV. The Prerequisites of the Open of Chinese Capital Account

In order to allocate the resources efficiently, we need to enhance the development of the efficient capital market. If there is not an efficient capital market in place, financial investors would have to incur higher transaction costs— extra time, effort and money. To smoothen the opening process of Chinese capital account, it is imperative for the Chinese top-level decision maker to understand the conditions on which the opening policies are based. It is widely believed that for the capital inflow, to open long-term capital account (E.g. long-term direct investment, long-term security investment and long-term government bond investment) will benefit the operation of domestic financial system and economic growth as well. It would be better to open the capital account along with the path of Chinese foreign trade system reform. Hence, there are no preliminary conditions for opening capital account for the long-term cash inflow to a country.

For the short-term cash inflow, however, there are some preliminary conditions that must be fulfilled. These conditions include the following.

(1) Free trade system has been established at least two year when capital movement limit is removed. We know that China's economy is in its transition period from planned economy to market economy. The market economy has been playing more important role for the growth of Chinese GDP. Well-developed commodity market, factor market, labor market and financial market are the basis to open Chinese capital account.

(2) In the first three years after the removal of capital movement limit, the average deficit to GDP ratio should not exceed 5%. Central government's fiscal policy is one of the most effective policies for Chinese government. The government should be extremely careful as far as financial deficit is concerned. Although Chinese government has good reputation in dealing its debt obligations in the history, it would be highly recommendable to control the deficit ratio fewer than 5% each year. The realization of this objective will allow the central government to control the speed of macroeconomic growth without incurring unnecessary financial distress.

(3) The financial system has opened to its domestic market for at least two years. An efficient domestic financial market is the foundation for the open financial system. This is because in an open domestic financial market, the financial assets' prices are set by the equilibrium of demand and supply. The participants of the financial trades have to get information about the financial market and obtain valuable knowledge to understand the market information in order to make a sound decision on buying and selling the assets. In this trading process, the market participants will become more and more rational so that their behavior will enable them to maximize their financial welfare.

(4) The entry limit for the banks (both domestic and international banks) has been removed for at least two years. Banks are the most powerful financial institutions in China. The increase of Chinese financial market efficiency is relying heavily on the banks' ability to eliminate the non-systematic risks, reduce their bad debts, and deal with their credit loan properly. Furthermore, Chinese banks, the state-owed banks in particular, need to improve their ability to innovate new financial instruments and management to cope with the new financial environment.

(5) The asset ratio of state owned banks has been bellow 40% of the total for at least two years. Nowadays, the non-state owned enterprises are playing more and more important roles in the growth of Chinese economy. The growing market share of the non-state owned business contributes to the growth of imp ort and export, the growth of GDP and the national employment. The decrease of the share of the state-owned banks indicates the improvement of the capital market efficiency.

(6) A market-oriented financial supervision system has been established. In the process of the transition from planned economy to the market economy, the role of the central government has been changed dramatically. The major economic management obligation of the central government has been shifted from direct management of the large state-owned enterprises to controlling the macro-economic performance indirectly. To make sound decisions and regulations, the officials of the government should have a good command of both the world economic development trend and domestic business practices. The ability of decision-making and economic management of the government ought to be improved in the process of economic development.

(7) Further reform of domestic enterprises. A large number of well-managed and operated enterprises are the foundations for a highly efficient capital market. The enterprises are the micro-basis of the economy to utilize the resources efficiently. At the time being, Chinese enterprises are still facing many difficulties in modernizing the management skills, production facility and technology.

In addition, the open of the cash outflow of a country, regardless of the term of the capital is long or short, relies on the following conditions:

(1) The domestic interest rate is liberalized. Domestic interest rate liberalization is a higher stage of preparation for the open of capital account. A liberalized interest rate regime will allow the natural resources to be distributed efficiently in a competitive environment. In addition, market competition experience will also educate investors to be more rational in dealing with their financial assets.

(2) Government economic policies are stable. A stable policy environment is the key aspect to reduce unexpected financial volatility as far as the capital account is open. It is the government's responsibility to make its financial policy relatively stable and foreseeable in order to build up the investors' confidence.

(3) The taxation system is effective. After the open of Chinese capital account, there will be more financial innovations coming up in the financial market. There are certainly advantages of these financial innovations, such as making the financial market more liquid and enlarging the financial market scale. In the down side of the financial innovation, however, it would be possible for some financial institutions and organizations to get the risk-less returns by taking part in taxation arbitrage if the taxation system is not modernized in time to cope with the complicated financial innovations.

(4) Chinese government controls enough foreign exchange reserves. Foreign exchange reserve in the central bank is one of the most effective financial tools of the central government to deal with the financial crises. Open Chinese capital account will require more foreign exchange reserves to meet the need of handling the unexpected capital movement and changes in financial exchange rates and interest rates.

V. The Procedures of the Open of Chinese Capital Account

Opening Chinese capital account should be a long-term process, rather than a one-shot task. We know that there is an inherent contradiction between the efficiency of the capital market and the safety of the market operation. The implication of this inherent contradiction is that China's opening capital account strategy should based on such a sound principle that it will balance the two sides of the consequences of an open capital market. Therefore, to make a sound decision on the right opening procedure is the essential part of the success of the opening of China's capital account. A well-designed capital account opening procedure will enable us to do the right things in the right direction.

Based on the analysis above, I would like to suggest the following strategies in opening the capital account to embrace the new globalization era. There are should be three steps to further open Chinese capital account

In the first phase, which should start from now on and end in 2004, there are four major items need to be open.

(1) To remove the restrictions on foreign financial institution's security brokering business in China gradually;
(2) To loosen the requirements on domestic enterprises' issuing equity securities abroad (Hong Kong in particular);
(3) To loosen the requirements of on foreign corporations' (both in China and abroad) issuing equity securities in Chinese capital market;
(4) To loosen the requirements on foreign corporations' and financial institutions' issuing bond securities in Chinese financial market.

Up till now, the first two steps of these are already finished. The decision makers are considering the last two of these.

In the second phase, which will start from 2004 and end in 2006, there are six major items need to be open.

(1) To loosen requirements on Chinese financial institutions' setting up branches (including fund management organization) abroad gradually;
(2) To loosen the restrictions on Chinese financial institutional investors trading securities abroad (e.g. QDII);
(3) To loosen the requirements on foreign financial institutions and institutional investors' setting up wholly owned organizations; remove the limit on the maximum shares of 49% of the foreign partners in the joint-ventures in China;
(4) To loosen restrictions on Chinese financial institutions' and enterprises' issuing corporate bond in foreign countries;
(5) To loosen the restrictions on foreign financial institutions' trading securities in Chinese financial market;
(6) To remove the restriction on Chinese enterprises' direct investment in foreign countries and remove the restrictions on Chinese individuals' direct investment in foreign countries.

In the third phase, which will start from 2007, there are four major items need to be open to the foreign investors and financial institutions.

(1) To remove the restrictions on foreign individuals' investment in Chinese security market gradually;
(2) To remove the restrictions on foreign financial institutions' and institutional investors' trading financial derivatives in Chinese capital market gradually;
(3) To remove the restrictions on Chinese financial institutions, institutional investors and enterprises' issuing and trading securities in foreign financial market Completely;
(4) To further the process of foreign exchange rate system reform and make RMB convertible in the capital account.

Financial management, even in a domestic environment, is one of those curious combinations of mathematical precision with the prime source of all random behavior--human behavior. When financial management activities must stretch across geographic, cultural, political, and jurisdictional boundaries, the attention paid to organization and goals becomes critical. In conclusion, it is worth to mention that the procedure of opening Chinese capital account is a continuum rather than something uncorrelated. It would be wise to interpret them not in absolute terms. Moreover, these steps of opening capital account are "conditional". In other words, there are some preliminary conditions. If the preliminary conditions are not matched, a rash open of the capital account will probably result in unexpected financial and economic disasters and even social turmoil. Furthermore, the steps of opening capital account constitute a "gradual" process. Here the word "gradual" means that it is a complex one. We can neither unreasonably accelerate this process to reach the target, nor miss the opportunity without noticing it.

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End Notes

i The table was edited according to the information in the Appendix of IMF,Exchange Arrangement and Exchange Restrictions, which was translated by China National Foreign Exchange Management Bureau, China Finance Publishing House, 2000.

ii Since the classification in the <International Balance Sheet> published after 2000 is relatively simple, we use the one published in 1999, which reflects Chinese capital account in more detail.

iii <China Security Daily>, 2002,10,12.

Is Barter Still Relevant in The New Millennium?

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Abstract

Barter is the direct exchange of goods between two parties in a transaction. Barter is often regarded, as an old fashioned idea that enables business to buy some needed products and services in exchange. It involves the exchange of goods or commodities without the use of currency. For example, all members of our society have participated in some form of bartering, from our children trading baseball cards and video games, to some of the world's largest corporations exchanging unsold inventory for other goods. Businesses of all sizes are trading goods and services through such commercial operations as the Barter Business Exchange and in the process are solving cash flow problems, increasing sales, and getting rid of excess inventory. Barter allows you to buy what you need to pay for it with unsold products and services---without the use of cash (Healy 1996, p38). A leading barter company executive, when asked, "How big is the barter business?" responded by saying "No one really knows how big it is because companies won't talk about it." "They're not advertising it," he said. "They don't want their competitors to know about bartering." Whatever it is— surplus or seasonal inventory, a discontinued line, canceled orders, store returns—-you can trade it, rather than liquidate it, and recover the value that has been lost," says an executive of one of the oldest bartering companies in America (www.barterworks.com).

Introduction

Most people regard bartering as a primitive form of trade best suited to the Dark Ages, when beads could be exchanged for food. But it has ridden into the 21st century on the back of the Internet: Now it allows businesses to trade unsold inventory for goods that they need, without spending valuable cash. Hotels, for example, can trade vacant rooms to advertising agencies for free ad space. Barter networks like the one run by Barter card allow companies to expand through bartering one-to-one. United States based e-commerce site Asia4sale.com, which runs BarterAsia.com, says its new online exchange in China is already registering a modest number of commercial and industrial deals. The Thai government last month confirmed it was considering a deal with Malaysia to swap good for crude oil (International Business Asia, March 2, 1998). Business to business bartering is flourishing on the back of online banking technology. The International Reciprocal Trade Association, a U.S. based organization that represents 180 barter networks, says more than 500,000 companies' worldwide barter, and it expects the industry to grow 15% a year over the next decade. That is great for the founder and managing director of Barter card, Andrew Federowksy. Federowsky claims that it is the world's busiest barter site and he expects its annual worldwide turnover to top billion this year (Eastern Economic Review May 10, 2001).

Many companies are involved with barter. Nationally and internationally, over 250,000 businesses are involved in barter. It is estimated that 65% of the fortune 500 companies engage in barter to one degree or another. Included in the 65% are PepsiCo, Pizza Hut, Casio, General Electric, IBM, Amoco, Caterpillar, 3 M, Goodyear, Xerox, Pan-Am, Chrysler, and Hilton (www.barterworks.com). A recent innovation is bartering goods and services for excess office space. The many products that are bartered are trading advertising time, hotel rooms, or office equipment. Barter is making new roads in commercial real estate by bridging the gap between the book and market value of surplus building and leases. In exchange for the sale and lease of a surplus space, a barter firm issues trade credits at Permian of an asset's market value. An owner or tenant for advertising, travel, telecommunications, computer equipment, or the like subsequently uses the credits. According to Michael Bell, Vice President of barter company, The Intrac Group, "…barter provides enhanced value for excess inventory" (Ciandella 68). Barter allows firms to use excess inventory in order to finance the cost of operations and conserve cash.

According to the International Reciprocal Trade Association, 250,000 firms worldwide made $6.5 billion in barter deals in 1992, up from 180,000 firms and $4 billion in 1991(Ciandella 68). New data shows that there are over 400,000 firms worldwide today. Netscape Communications Corporation is the top vendor of the World Wide Web advertising and the fifth largest purchaser of the Web ads, has built its dynasty with the help from barter deals. The firm has recently renewed its contracts with their four search engines: Yahoo, Excite, Info seek Corp., and Lycos. Unlike its 1996 deals, in which search engines agreed to pay $5 million each to be premier providers on the search area of Netscape, each engine this year is paying on a cost-per-thousand impression basis. However, the overall investment should be fairly equivalent, according to Jennifer Bailley, vice-president of electronic marketing at Netscape. She says that the search engine contracts are heavily weighted on the "real cash" side but do involve barter. She adds that most of Netscape's advertising on search engines comes from barter agreements (Krause 30-2). Publishers and broadcasters have barter ads for a long time. Meanwhile, the Internet is shaping up as one of the most promising media for ad sales. Television networks are now exchanging airtime for equity stakes in start-up Internet companies. CBS Corp. and NBC have traded millions of exchange for stakes. CBS barters for stakes in Medscape and Sports line USA, while NBC trade for stake in iVilliage and Talk City. The networks hope the ad swaps will sell the charms of network-TV advertising to other Internet companies who would pay cash (Beatty b1-2).

Bartering is also a viable and attractive option for restaurant proprietors. By offering meals through barter, eateries can fill up vacant seats. Although there may not be instant return, each dollar given away is a dollar off the cost of a needed service. Using trade dollars instead of cash saves money and provides necessary working capital, reserve that is needed for more difficult times. Moreover, the word of mouth and advertising generated by these non-cash customers will entice both trade and cash customers to try out to eat (Meharg 28). Barter is a great way for growing or stable companies to conserve cash, reduce payable accounts, collect on old receivable, and get rid of excess inventory. The only companies that are not appropriate for a barter situation are those that have very specialized products and services that few people would need. Any company considering joining a barter exchange should visit the trade exchange to talk to the people who will service the account and secure a list of clients and the various products and services that they offer. It is important that barter exchanges clientele and have products and services that they exchange by contacting the National Association of Trade Exchanges. Lastly, a company should remember that every time they trade, they are taking inventory off the shelves or committing production time, or unless they have enough incoming cash to replace their inventory. And finally, they need to cover bills that they normally pay on a daily basis (www.bartertrust.com). In the U.S., approximately 100 corporate barter exchanges help large manufacturers, wholesalers, and distributors trade excess inventory. Unlike retail exchanges, which primarily serve the small-business market, corporate barter companies typically take ownership of customers' excess inventory as well as broker large-scale company-to-company deals. Corporate barter dollar volume in North America exceeded $9.27 billion in 1999, according to the Corporate Barter Council (CBC), a not-for-profit U.S. trade association (Linnett 2001 p59).

Reasons to Countertrade

Countertrade can be defined as a reciprocal exchange involving limited or no transfer funds. In its simplest form, it is trade without money (Kwabena & Harvey 1995). It also describes a multitude of trade arrangements, both domestic and international, in which goods, services, and technologies are exchanged in addition to or in place of money. Countertrade began as a simple barter. Although barter declined drastically with the invention of currency, it has resurfaced periodically, especially during times of economic stress. Given the political and economic pressures of many countries and the competitive world market, it is no surprise that countertrade represents a substantial and increasing part of global trade today (Kwabena & Harvey 1995).

There are many reasons why countries may consider to countertrade. They may want to preserve hard currency, improve their balance of trade, gain access to new markets, upgrade manufacturing capabilities, and maintain prices of export goods (Cateora 2001 p573). Countertrade is broken up into several components, one of them being barter. Barter is the simplest and oldest form of countertrade. It is a one-time, direct exchange of goods at equal value. Although money isn't usually exchanged, it isn't excluded. Letters of credit, performance bonds and similar instruments are sometimes used to secure delivery obligations. Pure barter, or trade without cash, is relatively rare in contemporary international trade (Kwabena & Harvey 1995). There are many advantages to countertrade and many good reasons why it should be used. The most popular reasons include a shortage of foreign exchange, restrictions on import license and as a devaluation hedge. Foreign exchange shortage can be further divided into three categories: blocked profit repatriation, blocked funds for trade debt and the availability of more favorable exchange rates (Cateora 2001 p570). By engaging in countertrade, countries are able to preserve hard currency by exchanging products for products. Countertrade makes possible sales that otherwise would not have been made and helps improve the balance of trade. Countertrade, if used creatively, is a way to expand sales to new markets, as it offers more flexibility in enhancing exports. One aspect companies do not think of in the early stage of a countertrade transaction is the accessibility of raw materials. One of the easiest ways for a company to move the countertraded products is to get a product that it needs, either as a raw material or as a finished product. Countertrading also broadens the accessibility to a new source of raw materials that may have a better price or quality.

At times, broader supply base works to the advantage of the company. It can also be used to establish and improve the company's relationship with the foreign government. With the exchange of products, the foreign government can have imported goods without using its reserve of hard currency. The other benefits that countertrading associates with is the fact that they are expanding the global market by gaining access to new markets; improving the quality and distribution of a country's products; and improving a method to manage exchange rate risk, clean up bad debt, repatriate blocked funds, and solve liquidity problems. In the coming years, the proportion of countertrade as a share of world trade is not likely to deviate very much from present levels barring a substantial decrease in the volume of world commerce. One of the best reasons to engage in countertrade is to combat the devaluation of a foreign currency. Companies lose billions of dollars to exchange rate fluctuations. Why waste time, money, and effort when countertrade is available? A company can protect itself against currency devaluation by accepting the customer's product as payment, rather than a soft currency that can devaluate drastically overnight. From a countertrader's perspective, the abovementioned obstacles are not problems but opportunities for increased sales (Business Credit April 2001).

Forms of Countertrade

Compensation Deal

This involves the payment in goods and in cash. The advantage of having a compensation deal over barter is that there is an immediate cash settlement of a portion of the bill; the cash that is leftover is generated after the sales of the goods are received. If the company has a use for the goods received, the process is very simple. Then again, if the seller has to rely on the third party to locate the buyer, the cost drawn in must be anticipated in the original compensation compromise if the net proceeds to the seller are to be equal to the market price (Cateora 2001 p571).

Counter purchase, or Offset Trade

This is probably the most frequently used form of countertrade, of which the seller agrees to sell a product at a set price to a buyer and receives payments in cash. Two contracts are then negotiated. The first is an agreement by the original seller to buy goods from the buyer for the total monetary amount involved in the first contract or for a set percentage of that price. This arrangement provides more of a time period in between deals and more flexibility. There is about 6-12 months to finish the second contract. During this time, the seller has received full payment for the original sale. Then, the goods that will be purchased in the second contract are by and large of greater variety than those presented in a compensation deal. Another way that makes the second contract to last even longer, is when the second contract is named as nonspecific. For example, books on sales and purchases need to be cleared only at certain periods. The seller is then required to produce enough purchases to keep the books stable or obvious between purchases and sales that are involved (Cateora 2001 p571).

The Product Buy-Back Agreement

This type of agreement is made when the sale involves goods or services that produce other goods and services, like, production plants, production equipment, or technology. The buy-back agreement usually involves one of two situations:

(1) The seller agrees to accept as partial payment a certain portion of the production,

(2) The seller receives full price originally but agrees to buy back a certain share of the output.

The only major downside to product buy-back agreements comes when the seller finds that the products bought back are in competition with its own produced goods.

Clearing Account Barter

In clearing account barter, clearing accounts are made to track debits and credits of trades. They only signify the purchasing power, but cannot be withdrawn right away. Each party can then be in agreement with a single contract to purchase goods or services.

Offset

An offset requires that portions of a product be produced or assembled in a buying country. For example, a country purchasing aircraft from the United States might require that certain portions of the aircraft be produced and assembled in the purchasing country. A newly formed kind of countertrade, which is used as a financial tool, is called debt swaps. These swaps are carried out with less developed countries in which governments face large debt (Czinkota 2001 p522).

The Effects of Currency Devaluation on Barter

Currency devaluation is usually the depreciation of a nation's currency implemented through a government action. When a nation's government notices a trend that it will be losing markets in the world market, it devalues its currency by lowering prices relative to other currencies without any changes on its domestic prices. One key effect of currency devaluation is that it makes the domestic currency cheaper when compared to those of other currencies. It also makes a country's exports relatively inexpensive for foreigners. On the other hand, it makes foreign products more expensive and beyond reach for domestic consumers thereby discouraging imports and encouraging exports. Therefore when a country exports more, they can ask for the hard currency. Exporting more means sending more goods or selling more while accepting needed products in return if they don't have hard currency. So, devaluation can stimulate the economy.

A country can barter more goods for goods. This can also help to reduce the current account deficit of a nation. Devaluation of a currency has its negative and positive impact and untold financial burdens on the poorest nations of the world. When a nation can no longer depend much on its export earnings as a result of the inexpensiveness and the trickle funds coming into it's treasury, the economy suffers (Aschkenasy 1996 p10). When a government devalues its currency, it is often because of interaction of market forces and policy decisions that has made the currency fixed exchange rate untenable. For a country to be able to sustain a fixed exchange rate, it must have sufficient foreign exchange reserves, often dollars and be willing to spend them to procure all offers of its currency at an established exchange rate. When a country is unable to do so then it must devalue its currency to a level that it is able and willing to support with its foreign exchange reserves. Rather than implementing unpopular fiscal spending policies, a government might try to use devaluation to boost aggregate demand in the economy in an effort to fight unemployment
(Goff 2000 p233).

Barter and Weak Money

Over the last three decades, several companies have been gaining a superior profit achievement through the recognition of opportunities in foreign markets. At the beginning, companies were only aware of the advantages of the international trade by exporting to and importing from overseas markets. The possible cost advantages from producing in foreign countries and the possible revenue opportunities from demand by foreign markets have encouraged firms to consider international business as a major concern to secure a profitable growth. A great example of this innovation is the Coca Cola Company, which is selling its products to over 160 countries and using 40 different currencies (Business Week, Sept.10, 1994). Many countries have money that is weak therefore they know they will bring back goods home via Barter techniques. Many times a weak country's money is not used in the world's Financial Markets such as China's "Yuan" and Russia's "Ruble." Pepsi sells Pepsi Syrup to Russia and gets Rubles. Then they spend Rubles back in Russia to buy vodka; sell vodka in the U.S. and Ahmad. Pepsi sells Pepsi Cola and buys back with Indian Rupees, rice, and spices.

Benefits of Bartering

Although barter and countertrade are an excellent way of exchange rather than the exchange of hard money, there could also be problems that come with that. Countertrade could pose some legal and financial concerns with the parties involved. Since countertrade involves more than a one-time deal, there could be some anti-trust issues that arise. In addition, companies must assess their tax liability amounts from all raw materials or other goods collected during these deals. Goods and services are considered taxable events under the tax code, however enforcement of this is often difficult since no actual currency is changing hands. Countertrade often conflicts with policy issues as well. It is viewed by many as an impediment to "free trade" since it can be coercive, anti-competitive and discriminatory. No tariffs are generally imposed on these transactions. It is also viewed as a way to "dump" undesirable products on an unsuspecting foreign entity (Business Credit, April 2001). Countertrade supporters believe that it is instrumental in accelerating the industrial development of the developing nations. There is also a major impact on the U.S. Economy.

United States labor groups have long argued that products imported through countertrade results into significant losses of jobs. During a recent congressional hearing, the topic of military related countertrade was discussed. The AFL-CIO testified that it deprived the United States industrial base of "essential capability and capacity". As more and more manufacturers are reaping the benefits of barter transactions, yet they should be aware of pitfalls involved. In a typical exchange, barter companies give a manufacturer trade credits that are redeemable for media in exchange for the manufacturer's obsolete or excess products. As the barter companies purchase products in bulk, they can negotiate favorable pricing for it. The barter company then sells the goods at a price that covers the cost of the product and provides for a profit. However, even as barter grows, it remains somewhat shrouded in secrecy, and many firms are reluctant to exchange such information (Business Credit, April 2001). There are many benefits that bartering conveys towards our society. A recent survey taken by AMR Research found that excess consumer goods inventory would exceed $60 billion in the U.S. and $120 billion globally by the end of this year. Until recently, businesses had few choices for disposing of excess assets. In most cases, they could either donate the products and take a tax deduction or turn the merchandise in for cash through a traditional liquidator or auction. Either way, businesses could expect to salvage only 5 percent to 30 percent of the product's original cost (Linnett 2001 p.59).

Barter in the New Age

Barter is back, but this time it has a new, more polished name: corporate trade. Whatever the name may be, the concept remains the same and it may have a new appeal to a tough economy. Marketers short on money that want to buy ad time and space use barter deals to trade unsold inventory for media credits (Advertising Age Feb 19,2001). Barters work in different ways. A barter company buys the excess inventory at full value from a company, and uses the trade credits and cash to help fill the needs of other barter customers. Barter exchanges (also referred to as networks), charge monthly maintenance fees ranging from $10 to $25, transaction fees from $5-$15, and membership fees from $100 to $700. It works very similar to a checking account. Although the actual trade is paid for in barter dollars, real currency must be used to pay fees, taxes, and any freight expenses. The barter exchanges report of their transactions to the Internal Revenue Service on form 1099B at year-end. A recent noted transaction was a graphic arts company who moved into new offices without spending cash. They paid for it with their printing services. According to the International Reciprocal Trade Association (IRTA), the number of clients for the barter exchange companies has increased from 17,000 to 300,000 since 1974. Included in these numbers are companies such as General Motors, 3M, AT&T, Fuji Film, and baseball teams such as the Chicago White Sox. Some major television networks including Fox have created bartering divisions within their organizations. In 1990, the Advertiser Syndicated Television Association expected bartering advertising revenues in excess of $1.25 billion (Financial Management 2001)

Something to Learn From Companies Associated With Barter

The many companies that are associated with bartering and show us the newest forms of bartering in our new millennium age are many. Euro Barter Business is a network that uses transferable credits to facilitate exchanges of goods and services. Bartercard is also a new and large international computerized bartering system that started in Australia (Fisher and Harte 1985). BarterNet is the Online Barter Association's website. Contranet is an Irish Barter Exchange system. LassoBucks is a barter network utilizing an alternative currency system so that businesses can trade excess time, inventory, or capacity for other goods or services that they might need (www.bartertrust.com). While barter has operated only in a few companies, several big players are now giving it a try. North Communications' KSL Media has launched a joint venture with barter company Corporate Trading Solutions, and Carat North America has set up Carat Exchange, a joint venture with an unidentified bartering company.

This year's softening of the U.S. economy has clearly played a role in barter's revival (Advertising Age Feb.19, 2001). KSL's model is to create barter deals through a third party, in this case, CTS. For example, if a computer company comes to KSL to buy ad time and doesn't have the budget to do it, but it does have unsold inventory to exchange, KSL brings in CTS. CTS will then take the inventory and convert that into media credits. Kal Liebowitz, CEO of KSL, admits that the arrangement is not at all like a typical one to one barter between a client and a media owner, brokered by a media agency, in which an airline will furnish plane tickets to a network in exchange for airtime. Instead, CTS takes a company's inventory and immediately converts it to cash credits, which it then turns over to KSL to buy media Liebowitz states that they are the only ones with this new way of bartering, and that they are a consulting firm that uses corporate trade as a marketing solution (Advertising Age Feb.19, 2001).

Airline Reservations Network in Orlando, Florida, sold $800,000 worth of airline tickets last year without receiving a dime. How? Company President Scott Bender says it is because of barter. They barter airline tickets for printing, advertising space, and employee benefits. He says bartering boosts their profitability by opening up a whole world of opportunity (Linnett 2001 p59).

Advantages of Bartering

Bartering is also advantageous for smaller business interested in saving money. A printing shop, for example, can finance the purchases of goods and services it needs by trading unused printing capacity (The Economist (US) Oct.21, 2000). It also helps in getting new businesses. "When someone joins an exchange, they're exposed to thousands of potential clients" says Tom McDowell, former director of the National Association of Trade Exchanges. Also, since few businesses run at full capacity, barter can help you squeeze extra profits from unsold or underused products and downtime (Home Office Computing Sept.2000). In addition, you can use your extra barter income to offset normal operating expenses or to cut costs. Jason Perry, President of Azavar Technologies in Chicago, uses barter for printing, restaurants, and employee rewards. "We provide employees with barter credits to spend as they wish," says Perry. "It's like an auction where employees don't spend any of their own cash, or mine" (Home Office Computing Sept.2000). Barter also gives home based businesses the chance to trade both nationally and internationally. "Internet bartering transcends geographic limitations," says BarterTrust.com CEO Mike Edelhart. "It puts companies in contact with good products and services in places they wouldn't otherwise know about" (Home Office Computing Sept.2000).

Tax Advantages Associated With Barter

There are also tax advantages that barter is included with, for example, barter income should be viewed as a company would as cash income. There are no inherent tax advantages or disadvantages just because a company uses a barter exchange. Barter is a marketing tool, not a tax tool. Generally speaking, as with cash income, barter purchases that are business-related are deductible, and conversely, barter purchases that are made for personal use are not deductible. Naturally, a company's barter income (sales) and business deductions (purchases) should be accounted or separately on a companies tax return. Although, as the commercial barter industry has matured, it has achieved recognition in the laws of the United States. Barter Exchanges are legally third party record keepers on a par with banks, credit card companies, and other custodians of taxpayers' financial records. Barter exchanges also have responsibility imposed by law to provide the IRS with the information on the barter income of each client (Healy 1996 P10).

Bartering on the Internet

The Internet offers a variety of changes for barter. The exchanges of goods and services remain mostly a local matter, but the Internet is taking barter to new heights. Exchangemall.com, the virtual marketplace for commerce without currency, sets the new standard for barter in the global economy. It is designed to meet the needs of everyone, from the largest of Fortune 500 companies to the individual consumer (Link-Up Jan.2001). Mark Savoy, CEO of Exchangemall.com, stated that in the electronic age, we are already moving towards a cashless society, and barter is simply taking it one step further. This web site unites people who seek to barter their products or services in a secure environment and enables them to make a trade with another person for his/her product or service. Users can trade goods for goods, goods for services, and services for services. They can create a personal "store" to barter their wares. After a product or service is listed and assigned a value, users wait as exchangmall.com barter dollars, as well as currencies from all other exchanges, to buy goods and services outright, or they may make a monetary transaction. Exchangemall.com credits a user's account after their product or service has been "purchased" by another user. This one-stop online barter system allows users to quantify their goods in monetary and non-monetary terms as well as to negotiate what products and services they want in return for them (Link-Up Jan.2001).

Many people feel that online bartering is not the best way to get what they need. These common consumer-to-consumer barter sites include MrSwap.com, WebSwap.com, Switchouse.com, and SwapVillage.com. These sites will most likely tell you to fill out a list of your "haves" and "wants" and you will be matched with people who have what you want, as well as people who want what you have. Items that are exchanged include anything and everything; books, CD's, games, DVD's, art, furniture, etc. However, finding a match can be difficult, and many times if a match is found, they may not respond to your email. No shows are a problem with many of these sites, but there are many other things to consider. If someone does respond to your email, you need to have something to send back to him/her, since that is the whole point of bartering. That is the main dilemma with these sites; it is rare that the person who has the item you want will also want any of the things you are offering them (Goff 2000).

Types of Barter Exchanges

There are two types of barter exchanges. Retail exchanges, of which there are over 400 in the United States today, allow mostly small businesses and individuals to trade with each other, with the exchange facilitating the trade, providing a common currency or "trade credits" and receiving a transaction fee for each trade. For example, let us say that the owner of a sign painting company needs some brochures printed. Instead of paying cash, he goes to a printer within his barter exchange and pays with trade dollars. The printer doesn't have to spend those with the sign painter. He may decide to eat at a restaurant or seek legal advice for his business (Linnett 2001 p59). The other type of barter exchange is corporate barter. It involves millions of dollars worth of goods, services, and raw materials. It is primarily conducted on behalf of large companies. The major goal is helping "sellers" obtain cost-of-goods value for their obsolete or excess goods. Corporate trade helps minimize loss from perishable goods, reduce inventory storage costs, extend geographical distribution and tap liquid assets. Income from barter is used to finance equipment and capital assets or to offset other business purchases (Linnett 2001, p 59).

Conclusion

The question that many people ask, "Is barter still relevant in the modern world?" Barter and money are not necessarily completely incompatible. One of the most important improvements over the simplest forms of early barter was first the tendency to select one or two particular items in preference to others so that the preferred barter items became partly accepted because of their qualities in acting as media of exchange although, they still could be used for their primary purpose of directly satisfying the wants of the traders concerned. Barter still often plays an important role in trade with countries whose currencies are not readily convertible, e.g. the communist countries during the cold war. At the retail level barter has become the main means of exchange on occasions when currencies have collapsed completely as a result of hyperinflation, e.g. in Germany after the two world wars.

There is a definite popularity barter has begun. It should be important to have an equal exchange of goods, but we all know that it is impossible. As long as firms are willing to sell their goods, others will buy goods in return. In conclusion, companies are selling and buying goods to their advantage.

References

Contact the author for a list of references.

Some Accounting and Technical Problems with Antidumping Trade Cases Involving Transition Economies: A Russian Case Study

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Abstract

Antidumping laws have been on the books for many years, but it has only been in the last few decades that they have taken on such a degree of importance. As World Trade Organization rules reduce the importance of tariffs and quotas, antidumping laws are rising to take their place as a major tool of protectionists. There is controversy about the methods used to calculate the cost of production. Calculation difficulties are compounded when the target country is labeled as a nonmarket economy, which was the case with Russia until April 2002, since cost figures of surrogate countries are used to estimate production costs and profit margins.

This paper reviews the literature on this subject and reports the results of the authors' review of public documents from dumping cases and interviews conducted in July and August 2003 with individuals experienced with Russian antidumping cases.

Introduction

Although this paper focuses on antidumping cases involving Russian products, the same administrative procedures, rules and principles apply to any antidumping case involving a nonmarket economy, and almost all of these same procedures, rules and principles apply to target companies located in countries that have market economies as well. Thus, the applicability of this study extends beyond Russia, Eastern Europe, China and other countries considered by investigating authorities to be non-market.

A foreign firm can be charged with dumping if it either sells its product on some foreign market for less than the cost of production or if it sells in the target market for a price that is lower than the price charged in the home market. Antidumping laws have been on the books of some countries for two or three generations but they were seldom used as a means of blocking trade until the 1970s. They have become more important since the advent of the World Trade Organization (WTO), for at least two reasons.

For one, the WTO has rules about dumping and WTO members that previously did not have antidumping laws are starting to adopt and use them. Secondly, with the decline in tariff rates and the liberalization of quotas, nations that want to resort to protectionism find tariffs and liberalized quotas less effective than before. Antidumping laws are being used to fill the gap that was formerly provided by tariffs and quotas, since they can be used as tools by domestic producers to thwart competition from foreign companies.

A Review of the Literature

Although much has been written about antidumping in both the economics and legal literature, practically no one has addressed accounting issues. One article that does focus on accounting issues in antidumping cases was written in 1990 by Bollom and Simons [5] and presents an overview. The authors of this article take a public policy perspective and call for further research. Davis and May [12] examine the way the Commerce Department computes the cost of production, but their study focuses only on how interest expense is treated in a Korean antidumping case involving sweaters. Kaplan, Kamarck and Parker [19] do a thorough job of analyzing the costing rules in antidumping cases, but the rules have changed since their article was published. A classic exchange of views on cost of production theories in general was published in the 1930s between Abramson [1, 2] and Neal [31] in the American Economic Review. Canning [10] wrote a classic article on the cost of production but did not apply it to antidumping cases.

A court case, NAR, S.p.A. v. U.S., 1989 [30] held that the use of average prices for comparison purposes was unfair in a case involving the importation of plastic tape from Italy. Yet this practice continues. This case also examined how transportation costs and exchange rate data can be used in computing the cost of production.

A few studies have addressed exchange rate issues and how exchange rates can affect the calculation of antidumping margins [32, 52]. The Commerce Department's use of best information available has also been examined by McInerney & Giesze [27] and criticized by Bovard [8].

Several studies have criticized antidumping laws in general, or how the rules are applied in certain cases [11, 13, 18, 48]. A 1979 study by the United States General Accounting Office criticized the antidumping laws for being too costly, time-consuming, complex and imprecise and also criticized the way cost comparisons are made by the Commerce Department [34]. It also criticized the Commerce Department's practice of ignoring sales at prices that were below average prices, since the effect was to increase dumping margins. More recently (2002), Kim [20] makes the same criticism.

Bovard criticizes antidumping laws for being unfair to producers in Eastern Europe in general [6] and Russia in particular [7]. Moore[29] found that the rules may be biased against developing countries. Applying special antidumping rules to a nonmarket economy has also been criticized by a number of authors over the years [4, 16, 17, 24, 49, 50, 51]. Meszaros [28] and Lantz [22] examined the application of these rules to cases involving Chinese and Russian companies.

McGee [26] and Caine [9] have called for the repeal of the antidumping laws because of their inherent unfairness. Other scholars have merely called for their reform [14, 21]. Several historical studies have also been made of the antidumping laws [15, 25].

Russian manufacturers of urea and ammonium nitrate have been the targets of prior antidumping investigations. In 2001 the European Union extended its antidumping measures against Russian companies out of the fear that failure to do so would result in continued dumping [3]. The U.S. Commerce Department has also investigated the dumping of ammonium nitrate by Russian firms in 1999 [45, 46] and 1998 [47]. The 1999 investigation calculated the dumping margin for both JSC Azot Nevinnomyssk and Russia-wide to be 253.98 percent. The 1998 study did not result in any antidumping penalties. Urea from Russia or the Soviet Union has been a target of antidumping actions for a long time. In a 1987 case, the Department of Commerce substituted U.K. natural gas prices for USSR prices to overcome the advantage that the much lower USSR prices would other wise enjoy [7].

Russian companies have been the targets of antidumping investigations for other products in recent years as well. Many of the other investigations involved steel products. The silicon metal investigation was concluded in 2003 [36, 41]. Investigations of cold-rolled steel products [37, 42], ferrosilicon [38] and structural steel beams [39, 43] were completed in 2002. The preliminary report on the ferrovanadium and nitrided vanadium case was issued in 2001 [44] but no further reports have been issued, which likely means that the case was settled before reaching the final investigation stage.

The authors note that Russia is not a member of the WTO and therefore does not have the protections of WTO antidumping rules. Russia is now negotiating its accession to the WTO and is expected to join in the coming years.

Accounting Issues

Although antidumping laws are primarily concerned with the theory and practice of international trade, there are a number of accounting issues involved, especially in the measurement of the cost of production and in the calculation of dumping margins. The way prices for product costs are computed and compared have been criticized. The Commerce Department often ignores individual selling prices that are below average cost while including individual prices that are above average cost, which tends to increase the dumping margin [8, 34]. This zeroing technique was found to violate WTO antidumping rules in a recent case brought against the EU by Indian manufacturers of bed linen but it continues to be used by the U.S. Commerce Department [53].

Price comparisons are sometimes made between products that are dissimilar without discounting for differences. Comparing prices from different periods can also distort results, especially if exchange rates have shifted or prices have either been increasing or decreasing rapidly [54]. In a Brazilian case involving steel wheels, the Commerce Department computed the U.S. selling price using the exchange rate in effect at the date of the sale but based the company's cost of production on the rate that existed when the product was exported, several months later. In another case, a fresh flower in Amsterdam and a wilted flower in New York were considered equivalent. No allowance or discount was made for the difference in quality [8].

The Commerce Department has been known to add 10 percent administrative overhead and tack on an 8 percent profit margin to the cost of production in a one-size-fits-all sort of way without considering either the industry involved in the investigation or the actual administrative overhead or profit margin of the particular company under investigation. The result of this kind of accounting is to penalize the more efficient companies and reward less efficient companies.

The way the Commerce Department computes the cost of production has also been criticized. In one case involving a Brazilian company, the Commerce Department computed the cost of production ten different ways [8]. Such flexibility makes it impossible for foreign producers to anticipate what the Commerce Department will do if the company is targeted for an audit.

The Commerce Department has also been criticized for comparing prices in dissimilar markets, comparing U.S. wholesale and foreign retail prices, disregarding volume discounts, and classifying costs as direct or indirect in an inconsistent manner. It has also been criticized for disregarding the cost information provided by the target company and verified by a Commerce Department audit and substituting information provided by the domestic producers who asked for the investigation, because such information is almost universally biased against the foreign company and is generally of a lower quality as well.

Urea Ammonium Nitrate

Introduction

Rather than merely presenting an overview of accounting issues involving several Russian cases it was thought that gathering some more specific information about just one case would serve to shed further light on the problems that Russian firms face when they become the target of an antidumping action. Interviewing individuals with practical experience in Russian antidumping cases was chosen as the means to gather this additional information. This methodology has not been used previously, as far as the authors could determine from their research of the literature.

The authors focused on the most recent Russian antidumping case involving a major Russian producer of urea ammonium nitrate solutions (UANS). Managers from Euro Chem, the holding company for Nevinka, were interviewed [www.eurochim.ru] There were a number of reasons why this firm was chosen. For one, it was involved in one of the more interesting antidumping cases. For another, and perhaps most importantly, the individuals who could provide the best information about the antidumping case were located in Moscow, a relatively convenient location. Most of the Russian firms involved in the other antidumping cases either could not be identified or located, or were located in cities that were not convenient to travel to for purposes of conducting interviews.

Several obstacles had to be faced and overcome to accomplish this task. For one, there are cultural biases that must somehow be circumvented if information is to be gathered. Russians and other East Europeans are extremely hesitant to discuss their business with outsiders. In addition, antidumping investigations concern very sensitive commercial information and companies fear that competitors might be able to profit from such information if disclosed.

The authors visited the Moscow office of the Russian company and interviewed employees who were involved with administrative, legal and accounting aspects of the case. The interviews proved to be very enlightening. The individuals who were involved in the antidumping case were quite knowledgeable and comfortable to discuss their antidumping experience. One official interviewed had an MBA from the University of

South Florida, a factor that enhanced the quality of the interviews considerably, since he was fluent in English and was familiar with American business.

One topic discussed that had relevance to many, if not all Russian antidumping cases was the cost of energy and the part it plays in the computation of the cost of production in Russian antidumping cases. One of the few comparative advantages Russia has is energy costs. Energy is substantially cheaper in Russia than in practically any other country in the world. That is because Russia has vast oil and natural gas deposits. Even though these resources might not be as efficiently exploited in Russia as in other countries, the fact that Russian companies have relatively low energy costs proved to be an important factor in their computation of production costs.

Another factor regarding energy costs is that natural gas prices are more volatile in the United States than in Russia. That has an effect on the demand for Russian fertilizer (urea ammonium nitrate). When natural gas prices are high in the United States, U.S. firms that sell natural gas decide to sell natural gas for heating rather than for agricultural purposes like the manufacture of fertilizer. The result is that the supply of natural gas available for the production of fertilizer in the U.S. is reduced, causing the U.S. agriculture industry to turn to Russia for its fertilizer needs. When the demand for Russian fertilizer (urea ammonium nitrate) increases, Russian firms that produce this kind of fertilizer operate at higher capacity levels, thus reducing the unit cost of production. If these production cost savings are passed on to their customers in the form of lower prices, the prices that U.S. and other foreign customers pay can be considerably less than the prices charged in the Russian domestic economy, thus triggering a charge of antidumping.

This energy cost advantage is not confined to fertilizer. It exists in any industry where energy costs comprise a material production cost. In the case of steel, for example, energy costs comprise between 60-70 percent of total processing costs. This comparative advantage works to the advantage of foreign consumers if energy costs are passed along in the form of lower prices. But foreign producers find that this Russian comparative advantage stiffens competition for them and causes them to lose sales and market share, thus providing ammunition for launching antidumping investigations.

The interviews produced new perspectives regarding the Commerce Department’s process not immediately apparent from the official public documents. While it cannot be said as a general rule that the U.S. Commerce Department’s staff that is involved in an antidumping dispute is highly professional and thorough, it could be said for this antidumping investigation (a sample size of one). The technical people the U.S. Commerce Department sent to review the Russian company books were fantastic, according to the Russian individuals interviewed. They knew the rules, knew what questions to ask and how to apply the accounting data to the rules. One woman spoke fluent Russian, thus dissolving any possible communication problems. These particular individuals were competent and professional. They were merely implementing bad policy.

Some Specifics of the Case

This investigation was launched as the result of a petition filed by the Nitrogen Solutions Fair Trade Committee, an ad hoc coalition of U.S. domestic producers that felt threatened by competition from urea ammonium nitrate solutions (UANS) producers from Belarus, Lithuania, Russia and Ukraine [40]. Lithuania was later dropped from the investigation because its exports to the United States were deemed to be negligible [35]. Coalition members included CF Industries, Inc., Long Grove, IL; Mississippi Chemical Corp., Yazoo City, MS; and Terra Industries, Inc., Sioux City, IA.

Natural gas is an important ingredient of UAN and accounted for 59 percent of the total cost of production of UAN for U.S. producers between January 1999 and September 2002, according to a questionnaire completed by U.S. producers that comprised 94.5 percent of total U.S. production [35]. As the price of natural gas fluctuates, this percentage also changes. Domestic producers purchase futures contracts to minimize the uncertainty of price changes. During the period under investigation, natural gas prices fluctuated, dramatically at times. Prices in the United States were less than $2 per MMBtu in early 1999 but rose sharply in late 2000 and early 2001, peaking at almost $10 per MMBtu, which was more than three times the historical price for natural gas [35]. As the price rose, U.S. producers of UAN curtailed production.

Transportation costs were also examined as part of the total cost of UAN. Average transportation costs varied between 24 percent and 49 percent of the cost of the imports, compared to domestic shipment costs of between 9.2 percent and 23.3 percent. The foreign producer share of the U.S. market also increased – from 2.7 percent of apparent U.S. consumption volume in 1999 to 8.8 percent in 2000 to 13.5 percent in 2001.

After all data had been examined, the Commerce Department calculated final antidumping margins to be:

226.82 % from Belarus,

193.57 % from Ukraine, and

between 106.98% and 239.14% from Russia.

The Russian company that cooperated in the investigation (Nevinka) received the lowest antidumping penalty. Russian companies that did not fully cooperate in the investigation received the highest penalty margins. Either rate would be prohibitive in a commercial sense, so in fact there was no practical difference between the two rates.

This differential penalty is in keeping with Commerce Department methodology, although its fairness is questionable. This procedure can be criticized on several counts. For one, the penalty should be based on the degree of dumping that has actually occurred. If that is the case, the fact that some targeted companies cooperated in the investigation while others did not should be irrelevant. Another criticism that could be made is that the data used to calculate the dumping margins for the Russian companies that did not furnish 100% of the data the Commerce Department demanded is almost always biased in favor of the domestic producers that requested the investigation. The Commerce Department could, but does not discount this data when it estimates the dumping margin. A less biased approach would be for the Commerce Department to make its own cost estimates, rather than use the data supplied by the petitioners.

The Surrogate Country Rule

Since Russia was, at the time of this investigation, classified as a "non-market economy," the Commerce Department felt justified in selecting costs and prices from a surrogate country. It considered Colombia, South Africa, the Philippines, Thailand, Tunisia and Egypt as possible surrogate countries because these countries were, according to the Commerce Department at least, operating at a similar level of economic development in terms of per capita Gross National Income (GNI). The petitioner asserted that South Africa was the most appropriate surrogate country and gave reasons why each of the other choices was not appropriate. As is usually the case, the Commerce Department agreed with the petitioner's choice, and South African prices were used as surrogates for Russian costs of production at the preliminary stage of the investigation (Fed. Reg. 67:97, p. 35495, 2002). However, the Commerce Department switched to Egypt at the final stage of the investigation because Egypt had recently become a huge producer of natural gas (Fed. Reg. 68:41, p. 9979, 2003).

Such a methodology has a number of weaknesses that any economist who does not work for the Commerce Department or for a petitioning company would quickly point out. Perhaps the most glaring weakness from the standpoint of economic methodology is that it is not appropriate to choose a surrogate based on general similarities, and then use actual data from some sub-part for comparison purposes. For example, if the Commerce Department wanted to calculate the cost of growing tomatoes in Arizona, it could very easily choose to use the cost of water in Iowa, where water is abundant and cheap, rather than the cost of water in Arizona, where water is scarce and has to be piped in. Such methodology is inherently flawed, as well as unnecessary in cases where the target company provides relevant information. Yet there are no procedural safeguards to prevent the Commerce Department from using such inappropriate methodology.

This methodology also violates generally accepted accounting principles. But the Commerce Department and the U.S. government in general, are not obligated to follow generally accepted accounting principles. They are free to set their own accounting principles, since there is no accounting standard setting body above them to prevent them from making their own rules. This fact results in a structural weakness in antidumping investigations, since the rules cannot be known in advance and since there are no safeguards to prevent the Commerce Department from choosing biased rules that work against the foreign producers (and thus also against U.S. consumers, who must pay higher prices as a result). The U.S. General Accounting Office criticized the Commerce Department's methodology as far back as 1979 [34], but the Commerce Department continues to use approaches that violate generally accepted accounting principles, not to mention general notions of fairness [8].

Facts Available

One could dispute the fairness of the rules [9, 21], or how the rules are applied in other cases [8, 25], but not how the accounting rules were applied in this case, at least in a sense. Unfortunately, the accounting rules are not the only rules that the Commerce Department applies in antidumping cases. The Commerce Department officials found that almost all of the Russian company's costs of production could be verified. But almost all is not enough for the Commerce Department.

The Commerce Department has a rule called facts available, formerly called best information available 27]. This rule allows the Commerce Department to totally disregard any information the target company provides if the information the Commerce Department obtains is anything less than 100 percent of what it demands. That is what happened in this case. Even though perhaps as much as 99 percent of the information demanded was supplied, and even though the accounting data was exactly as originally stated, the Commerce Department rejected it and substituted its own figures instead. The reason why the Commerce Department disregarded all of the information provided by Nevinka was because it thought that Nevinka did not answer some of the questions in the Commerce Department's questionnaire in sufficient detail. So even though the information furnished by Nevinka could have actually exceeded 99 percent of the information requested, all information supplied by Nevinka relating to the cost of production was rejected. As a result, all of the time and resources Nevinka spent to gather the information demanded by the Commerce Department was wasted, since none of the information was used by the Commerce Department.

A great deal of time and effort went into the compilation of information. When the Commerce Department came to Moscow and then Nevinnomyssk, the location of Nevinka, to inspect Nevinka's records, they used a room about twice the size of the 15' x 24' room used during the interview. The room was filled with tables that had documents stacked a foot high. Much of the information examined had been translated into English prior to the Department of Commerce visit. Other documents were translated into English on the spot, as needed.

When the Commerce Department chooses to reject the data the target company has provided, it has a choice of alternative sources of information. It can use the information provided by the domestic producers who asked for the investigation to be launched in the first place, which is almost always highly biased in favor of the domestic producers. Or it can use data from a surrogate country. In many cases the Commerce Department uses information from a surrogate country that is gathered and supplied by the petitioners, who often also suggest which surrogate country is appropriate.

The Commerce Department obtained its data for natural gas prices from an article published on the internet. That price was used by the petitioners. Nevinka officials argued that that price was not a realistic price and was not even close to the average market price in Egypt.

Eurochem did a detailed investigation of Egyptian natural gas prices, which included a calculation of the average price of natural gas in Egypt. The Commerce Department disregarded that study and used the internet article instead.

Price Comparisons

Some price comparisons were made at both the preliminary and final stages of the investigation. At the preliminary stage, 61 comparisons were made between the prices charged by domestic companies and the prices charged by exporters from Belarus, Russia and Ukraine. In the period between January 2000 and March 2002, Russian exporters sold their product for less than the domestic producers 19 times and sold for higher prices 8 times. The results for Russia and the other two countries under investigation are summarized in Table 1.

At the final stage of the investigation, 95 price comparisons were made covering the period January 2000 to September 2002. In this comparison, Russian companies sold for less than domestic firms in only 14 of 41 cases. Russian firms charged higher prices in 66 percent of the cases examined.

These results are summarized in Table 2.

TABLE 1
PRICE COMPARISONS BETWEEN DOMESTIC AND IMPORTED UAN
JANUARY 2000 – MARCH 2002

	Total	Lower than Domestic	Higher than Domestic
Belarus	14	3 (21%)	11(79%)
Russia	27	19 (70%)	8 (30%)
Ukraine	20	3 (15%)	17 (85%)
Totals	61	25 (41%)	36 (59%)

Source: USITC Pub. 3517, p. V-12 [40]

TABLE 2
PRICE COMPARISONS BETWEEN DOMESTIC AND IMPORTED UAN
JANUARY 2000 – SEPTEMBER 2002

	Total	Lower than Domestic	Higher than Domestic
Belarus	26	9 (35%)	17 (65%)
Russia	41	14 (34%)	27 (66%)
Ukraine	28	6 (21%)	22 (79%)
Totals	95	29 (31%)	66 (69%)

Source: USITC Pub. 3591, p. V-30 [35]

If an unbiased economist were to look at these statistics, the likely conclusion would be that there was no predatory pricing but merely price competition. It is difficult to conclude that predatory pricing exists when the Russian firms charged higher prices than domestic companies in 66 percent of the test cases. The Russian company that was the target of this investigation was not accused of predatory pricing, although one of the economic theories underlying the antidumping laws is the prevention of predatory pricing.

The antidumping rules in the United States operate under a bifurcated system, which has been criticized for its inefficiency as well as the uncertainty such a system produces [23]. The Commerce Department decides whether dumping has occurred and the United States International Trade Commission decides whether the U.S. domestic industry has been injured. In the case of Russian urea ammonium nitrate, the Commerce Department decided that dumping had occurred, but the USITC decided that there had been no injury to the domestic industry as a result of the dumping. Thus, the Russian firms won the case, but only at great cost. Smaller firms would not have been able to incur the costs of defense.

Costs of Defense

The cost of defending against an antidumping investigation can be staggering, especially for a smaller company. An American law firm with an office in Washington, DC must be retained, since the case must be argued in Washington. The law firms with the most expertise in this area are the large firms that charge high hourly rates. Some antidumping cases cost more than $1 million to defend. Others cost less. A mid-point might be around $500,000.

In all cases, the targeted firm must also expend resources locally. It might retain the services of a local accounting firm, and it definitely will use a great deal of internal man-hours to gather the information the Commerce Department demands. The firm's employees must work extra hours, sometimes for extra pay and sometimes without. But perhaps more importantly, they must be diverted away from their other activities, activities that could otherwise produce profits for the company. This diversion causes the company to operate less efficiently, although the amount of economic harm that results from the diversion of resources is difficult or impossible to estimate. A reasonable estimate of labor hours lost might be between 10,000 and 20,000. Monetary figures are difficult to estimate, since a number of employees are involved in gathering information and coordinating the effort, and they earn a wide range of salaries.

Nevinka also had to spend a great deal of effort, first to get the opportunity for the suspension agreement, and then to get acceptable terms. But the terms of the suspension agreement turned out not to be good at all. The suspension agreement prohibited it from making any sales in the United States for about a year. Since the United States is one of only two big markets for the firm's product (the other market is the EU), cutting off one of the two revenue spigots for such a long period resulted in major revenue losses. Prior to the antidumping investigation, Nevinka exported over 500,000 metric tons of UAN to the United States each year. At a selling price in the range of $100 per ton, that amounts to over $50,000,000 in annual sales. In 2002 it could only export one-third of the normal amount, which resulted in a substantial loss of sales, perhaps $34,000,000. In 2003 it was not allowed to export anything to the United States until the end of March, the time of the ITC's final determination, and then spent another three months striving to regenerate sales, which resulted in additional lost sales of perhaps $25,000,000 during the first half of the year.

But that is not the end of the story. Nevinka uses a process costing system because it processes raw materials to make several different products at the same time. Technologically, production of UANS at Nevinka is also interlinked with production of other fertilizers. Since the demand for UAN had shrunk drastically, it was forced to cut back on the production of the other fertilizers it made. Production cutbacks and the resulting lost sales for these other products was also substantial but difficult to estimate. If the lost sales from these other products were one-third of the lost UANS sales, then Nevinka lost additional sales of about $11,000,000 in 2002 and $8,000,000 in the first half of 2003.

TABLE 3
SUMMARY OF COSTS OF ANTIDUMPING DEFENSE

Legal and accounting fees	$500,000+
10,000 – 20,000 hours of employee time	???
Lost sales from:	
UANS in 2002	$34,000,000
UANS – 1st half of 2003	$25,000,000
Other products in 2002	$11,000,000
Other products – 1st half of 2003	$8,000,000

Concluding Comments

"Won" is perhaps not the best word to describe the result in the UAN case. While it is true that the USITC found that the U.S. domestic industry was not injured as a result of the dumping, the Russian company had to spend a great deal of financial and human resources to defend itself against the antidumping charge. It also lost nearly $100 million in sales during the period when it was not allowed to sell in the United States. Furthermore, being targeted for investigation produced a chilling effect on price competition. In order to avoid antidumping charges and further investigations in the future, the Russian firms have a tremendous incentive to raise their prices, thus making them less competitive in international markets. However, even raising their prices does not guarantee that they will not be targeted in the future, since domestic producers have little or no downside risk of asking the Commerce Department to launch further investigations. Luckily for Nevinka and the other Russian firms that were targeted, they won the case at the USITC level. If they had lost, the antidumping margins calculated by the Commerce Department would have forced them to raise their prices so high that no one would buy their products. They would have been shut out of the U.S. market. Consumers, including the agriculture industry in the United States and everyone who consumes food made in the United States, are also harmed as a result of this antidumping investigation. If the Russian firms that make urea ammonium nitrate feel compelled to charge higher prices in the future, the consumers of this product must also pay higher prices for it. The U.S. agriculture industry is one of the most easily identifiable victims of this investigation, but it is not the only victim. Any firm that uses urea ammonium nitrate will be faced with higher prices, as will consumers of any product that is made using urea ammonium nitrate. Thus, a secondary victim of this antidumping investigation will be anyone who consumes U.S. agricultural products, since the U.S. farmers will try to pass along the extra cost they incur in the form of higher prices for whatever product they sell.

In 2002 both the United States and the European Union reclassified Russia as a market economy. What this means is that the Commerce Department will no longer use surrogate countries to determine a target company's costs of production. However, Russian firms might still have to defend some of their costs.

For example, the EU continues to treat gas, electricity and transportation costs as those of a nonmarket economy, even though Russia itself is now classified as a market economy. Also, petitioners in future U.S. Commerce Department investigations might try to have some Russian company factor costs classified as those of a nonmarket economy. Natural gas prices comes to mind as one such price that might be challenged, since the price for natural gas in Russia is considerably lower than the price for natural gas in most other countries, including the United States. If this happens, Russia will be punished for trying to exploit one of its few comparative advantages.

In Russia's bid for WTO accession, there is a movement to have special rules such as the EU selective classification of Russia as a nonmarket economy. Russia would obviously prefer to have the same rules apply to it as to all the other WTO member states. It seems unfair to single out Russia for special treatment, especially when the treatment is likely to be adverse. So there is a fairness issue that needs to be resolved. The proposed two-tier treatment has been criticized in the literature [33].

Future investigations may target accounting differences. Russian Accounting Standards (RAS) are not identical to International Accounting Standards (IAS) or U.S. generally accepted accounting principles (GAAP). Inventory and depreciation are two areas that are somewhat different, and both of these areas involve items that affect the cost of production. These issues did not arise during the UAN investigation because the Commerce Department ignored Nevinka's cost figures and used Egyptian surrogate costs instead. But if surrogate country costs cannot be used in the future, more attention might be paid to Russian Accounting Standards and the differences between RAS and IAS or GAAP.

It is questionable whether it is fair or appropriate to apply U.S. GAAP to a Russian company's books. It is also somewhat hypocritical to do so, since the U.S. government does not use U.S. GAAP. It might be more appropriate to apply IAS, especially in cases initiated by the EU, since EU companies must adopt IAS by 2005. But even the forced application of IAS impinges on Russian sovereignty. Determining which set of accounting standards to apply is not easy, but such issues must be faced in the future, since Russia is no longer classified as a nonmarket economy and since RAS are not identical to IAS.

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Section 5
Risk and Business Strategies

Financial Risk Issues in Intellectual Capital: A Study of the E-Commerce Sector

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Abstract

This paper investigates the risk and return relationship of intellectual capital investments in relation to the informational efficiency of the security markets and predictability of stock prices. Both have been contentious issues in finance and predictability relates to what component of equity returns can be predicted give n specific information and the general awareness that in competitive markets there are no 'free lunches' to investors. In competitive security markets, the risk-return relationship explains the notion that higher expected returns come with the need to bear greater investment risk. The main focus in this paper is to identify the relevant risk factors and study how they should be measured to determine the appropriate risk premia and what should be the quantitative trade-off between risk and expected return for an investment that draws its value from predominantly intangible assets. The study of Australian high technology sectors in this paper provides an empirical identification and analysis of the economic factors that contribute to the value of intellectual property and draw from it the underlying issues of volatility and predictability in the capital markets.

1. Introduction

The dominance of intellectual capital as the basic element of wealth creation in all industries is highly evident today. The successful development and commercialisation of technological innovations depend, amid other qualities, on the ability to raise capital to fund the business process. It is from this perspective that it is crucial to understand the relevant capital markets pertaining to the funding of technological innovations and the role they play in ensuring the momentum of technological advance in the market is maintained. The decision whether to proceed with new product development should be based on an assessment of expected returns from the project against its risk exposure. Empirical evidence suggests that financial markets reward firms that embrace innovation (Cooper 1984). This tenet has since been compounded by the advent of financial deregulation and increased globalisation of capital markets where major equity markets around the world have witnessed increased upward trend in equity prices together with a heightened degree of idiosyncratic volatility in returns (Campbell et al. 2001; Oh 2002).

The central theme of this paper concerns the risk and return relation of intellectual capital investment and its implications for informational efficiency of the financial markets and equity price predictability. The risks associated with investment in intellectual capital are evaluated to account and explain investor's behaviour and to provide a rational framework for individual investors and firms in terms of the risks they are willing to bear and pay for.

The objectives of this paper are: firstly to highlight the emerging financial issues of risk and return pertaining to the development of intellectual capital, and secondly to explain the determinants, assumptions and implications of risk in equity valuation for intellectual capital and thirdly, the analysis of the financial markets relating to fund raising for intellectual capital investment. This paper provides both a literature review and an empirical analysis of some other important issues pertaining to risk and valuation in the intellectual capital financial markets and presents alternative hypotheses for intellectual capital pricing.

The paper is structured as follows: Section 1 summarises the risk-return issues pertaining to e-commerce. Section 2 provides a literature review of the financial theories, concepts, and models relating to financial risk and return, while Section 3 introduces the approach taken by this paper to evaluating risk and return for the e-commerce sector. Section 4 briefly explains the data collection and Section 5 presents the empirical evidence of the tests on the risk-return model developed in this paper and the portfolio analysis and implications. Section 6 presents the portfolio analysis of our study and Section 7 provides some conclusions to this study with particular emphasis on the implications of e-commerce stock risk-return on cost of capital and equity valuation.

2. Literature Review

This paper studies the role of risk in the valuation of intellectual capital by exploring the key elements of the discount rate and its calculation. This section provides an introduction to the use of the equity risk premium in business valuation and the underlying assumptions.

2.1 Risks and equity valuation

It is a common acceptance that all investments are made in an environment of uncertainty and the reward for holding onto an investment is the expected return. A fundamental principle of finance is that investors require a higher return to bear higher risk. The risk premium is used in the discount rate which ultimately determines the overall valuation of the investment. Arthur (1996) proposes the era of increasing returns in the intellectual capital-intensive sector (i.e. the new economy) where firms could achieve market capitalisations that took old economy firms much longer to achieve. This situation requires different investment evaluation techniques and management strategies (Bontis1996).

The theory of risk in investment underlies the consequences of undesirable outcomes and their implications to individual investors or firms. Thus when stock prices are volatile, this means that prices fluctuate widely and can be difficult to predict. The traditional approach used in estimating the equity risk premium is to use historical data implying past performance as representative of future events. However, Cowles (1944) and Kendall (1953) suggest that financial prices could not be predicted from either changes in the series themselves or from past price changes in other time series. This statement has more credence when applied to nascent firms, which possess relatively higher levels of intellectual capital and have less reliance on historical data for valuation. This paper adopts the historical approach in the absence of a more functional and general methodology for estimating equity risk. The relevant risk implications in this paper are the volatility risk associated with equity prices and the valuation of risk in the context of intellectual capital returns. Investment risk analysis involves studying the amount of uncertainty about future cash flows and risk from two perspectives, firstly the firm-specific or idiosyncratic risk and, secondly the portion of total risk that cannot be diversified away, the market or systematic risk. The price of risk in the equity capital market represents that part of total risk that cannot be diversified away or the concept of risk premium, the difference between expected returns and the risk-free interest rate.

To conduct risk evaluation, the process is to first measure the level of risk associated with a particular class of equity or market benchmark, in this case the Australian stock market index. The traditional measurement of risk in the financial literature is one that uses the mean-variance approach in financial asset pricing first proposed by Hicks (1946), Markowitz (1959) and Tobin (1958), who developed the portfolio theory that explains investment portfolios in terms of the mean-variance sphere. In this context, a well-diversified investor would choose mean variance efficient portfolios, being the portfolios with the highest mean return for a given level of variance. Therefore, the relevant risk that should be measured and compensated is only that an investment adds on to a diversified portfolio. This is followed by an attempt to capture the time variation in volatility using contemporary approaches such as those based on the parametric ARCH or stochastic-volatility models (see Campbell, Lo and MacKinlay 1997 for a review of these models).

The equity risk premium underlies the main cost of equity models such as the capital asset pricing model and Fama and French (1993) three-factor model. Both require an equity risk premium to estimate the cost of equity capital. The intangible nature and the phenomenon of increasing return make the estimation of the equity risk premium for intellectual capital more nebulous. The aggregate stock market is in general inherently volatile to varying degree over time and the complexities of valuation associated with intellectual capital will entail the development of more sophisticated statistical models in an attempt to discern the time variation in volatility.

The discount rate represents the inherent risk of the business in the discounted cash flow (DCF) approach. The fundamental principle of valuation by Miller and Modigliani (1961) under perfect competition is that the price of each share must be such that the rate of return, comprising of dividend plus capital gains per dollar invested, on every share will be the same throughout the market over any given interval of time. The value of all assets (in this case stocks*)* must comply with the law of economics where investors choose to allocate their scarce resources (capital*)* in order to satisfy wants (returns) according to personal circumstances (risk). The idea of the rational investor and the efficient markets hypothesis (discussed below) underpin stock prices and they reflect the true value of economic fundamentals and market efficiencies which will prevent attempts by investors to make excess profits. One of the fundamental principles of economics is that value is created by scarcity; in the late 90s the demand for ecommerce stocks appears to far exceed supply causing prices to escalate[i]. A proliferation of ecommerce stocks would likely satiate demand and cause stock prices to fall back into line with the general market (see Kindleberger 1989). As Porter (1980) emphasised, in a competitive market with free entry (the ecommerce sector has relatively low entry barriers), firms cannot earn sustainable supranormal profits indefinitely because that would encourage other firms to enter and drive down prices. This situation implicates the concept of efficient market hypothesis of an assumed world (Fama 1970, 1991). In such a market the share price will be an unbiased estimate of its intrinsic value, where investment value is the present value of the share's future cash flows as estimated by well-informed and capable investors.

2.2 Efficient markets hypothesis (EMH)

The recent e-commerce equity boom has been attributed to 'noise trading' (Black 1986) and this market situation implicates the concept of the efficient markets hypothesis (Fama 1970, 1991). Noise traders are not fully rational in their investment decisions and often overreact to fundamental news or are subject to systematic biases, such as positive feedback trading strategies, providing a reinforcing mechanism for market trends. The concept of EMH is that in such markets the share price will be an unbiased estimate of its intrinsic value, where investment value is the present value of the share's future cash flows as estimated by well-informed and capable investors. The EMH holds that the return of an investment is equal to its opportunity cost (allocative efficiency), stocks are always in equilibrium and it is impossible for an investor to consistently beat the market (information efficiency).

As EMH predicts that stock price fairly reflects all relevant information about the stock that has been fully revealed to the market, this price must represent its fair market value. Then stock price only moves in response to new information that, by definition, is unpredictable. Hence stock price should be random. Therefore, e-commerce stock prices must be fairly valued in market equilibrium situation. Information technology is interpreted as a fundamental factor transforming the real economy to high profit growth in the future (De Long 1996). In the context of EMH, this implies that the stock market reflects the future growth of the real economy because investors have incorporated this high growth expectation into their investment decisions and therefore fundamentally justifies the stock prices.

Schumpeter (1934) emphasised the important role played by the financial sector in economic growth and recently supported by King and Levine (1993). The benefits derived from the financial intermediation are through efficient capital mobilisation, risk management, project screening and monitoring and transaction cost reduction. These activities invariably contribute to market efficiency by addressing the problems of high transaction costs and information asymmetries (Pagano 1992). Therefore, information dissemination by the financial sectors about the real market factors influence economic growth and ultimately stock prices.

2.3 Applications of Equity Risk Premium

The discounted cash flow approach, capital asset pricing model and Fama and French (1993) three-factor model all relies on the equity risk premium to compute a cost of equity.

Discounted cash flow approach

The DCF method operates under the premise that the value of a firm is obtained by the sum of the discounted value of cash flows to be generated by the firm's existing assets and the present value of cash flows to be generated from future growth opportunities. While the financial performance of most e-commerce firms may not justify their market value (Bontis and Mill 2000), there is a need for a more profound understanding of the issues and a comprehensive valuation method to address the investment risk-return situation. This requires a clarification of the investment process and choices to help the investor overcome the ambiguity and identify the most appropriate valuation model to estimate the absolute investment value of an ecommerce firm and its common stock.

The two major elements in the valuation of e-commerce stocks, other than cash flow, are the potential growth and risk exposure of the firm. In the context of contemporary ecommerce stocks, the absence of positive cash flow poses a problem in adopting the DCF method for valuing an e-commerce firm. Even if positive cash flows can be reasonably estimated in the absence of historical earnings, the extrapolation of growth on earnings estimates might be based on weaker foundations. The Gordon Constant Growth model (below), which is a variation of the DCF method, create problems with valuation especially when the discount rate (k) and the assumed growth rate g are close, the result being highly sensitive to minor changes in the assumptions. For intellectual capital investment, this situation amplifies the importance of risk in determining the discount rate and the need to conduct an accurate estimate of growth. The discount factor in the DCF model provides for risk adjustment. When they are equal, the valuation is infinite.

$$V = \frac{D_1}{k - g}$$

where:
$V =$ the value of the firm;
$g =$ the growth rate;
$D_1 =$ the dividend in period 1; and
$k =$ the discount rate;

The DCF method is subject to manipulation and skewed results if the discount and growth rates are used without fully understanding the function and reflecting the underlying market conditions.

Capital asset pricing model (CAPM)

The CAPM is an economic model that predicts a trade-off between systematic risk, known as beta (?), and expected return under specific conditions stated as follows:

$$R_i = R_f + ?_i(R_m - R_f)$$

R_i = cost of equity for firm i;
R_f = risk-free rate;
$(R_m - R_f)$ = market risk premium;
$?_i$ = beta of firm i; and
R_m = market return.

The CAPM is an economic model that restricts the parameters of statistical models to provide a more constrained normal return. It proves that the relationship between prices of assets in a general equilibrium, where the investors select assets to maximise the mean-variance utility, is linear. Although the CAPM is widely used there are many criticisms (Roll 1977) against the CAPM. The evolving nature of the ecommerce sector creates a situation where information is dynamic with the constant introduction of unanticipated operating conditions in the industry, creating information surprises that may cause e-commerce stocks to move in a magnitude or direction not predicted by CAPM.

Fama and French three-factor model

The Fama and French (1993) model is an extension of the CAPM in which the cost of capital is estimated as follows:

$$E(R_i) = R_f + ?_{i1}(R_m - R_f) + ?_{i2}\,SMB + ?_{i3}HML \qquad \text{or}$$

$$E(R_i) - R_f = ?_{i1}(R_m - R_f) + ?_{i2}\,SMB + ?_{i3}HML$$

$E(R_i)$ = expected return for firm i;
$E(R_i) - R_f$ = risk premium for firm i;
$?_{i1}, ?_{i2}, ?_{i3}$ = regression coefficients for firm i;
$r_m - r_f$ = market risk premium;
SMB = size factor risk, i.e. difference between the expected return of a portfolio of small stocks and big stocks; and
HML = distress factor risk measured by book equity divided by market equity, i.e. difference between the expected return of high book-to-market stocks and low book-to-market stocks.

Unlike the CAPM, which uses a single factor – beta, the Fama-French model has three factors by adding the firm's size factor (*SMB*) and "distress" factor (*HML*) to the CAPM model. *SMB* – measures the difference in expected returns between small capitalisation and big capitalisation firms and *HML* – measures the historical excess returns of small capitalisation firms over the market and they represent the excess returns of "small-caps" and "value" firms over the market as a whole, respectively. The risk implication of the FF model is that high risk should be rewarded with high returns and that means that if returns increase with book-to-market ratio, the firms with high book-to-market must be more risky than the average firm. While a stock with high book-to-market may indicate a bargain stock, the EMH suggests that such a stock can only be a bargain because the market thinks it is risky. Unlike many traditional firms, intellectual-capital intensive firms are expected to have relatively low book value due to a high composition of intangibles in the asset base and high market value due to potential growth. They would normally be perceived as high-risk investments but EMH would dictate that such firms are priced because of their potentially high earnings and therefore should command moderate returns.

2.4 Valuation and risk issues of intellectual capital

A high proportion of investments in intellectual capital are made of start-up firms, which are in a nascent stage of business development and do not have the historical performance to list publicly. These firms are mainly funded by private equity such as venture capital and required returns for such capital are normally high. This is because intellectual capital investments carry more risk compared to most investments and the returns are expected to commensurate with the risk exposure. There is some degree of similarity in venture capital investments and listed small growth firms (Cochrane 2001) and this leads us to use the Australian ecommerce sector as the proxy to analyse the risk-return characteristics of the intellectual capital sector. There has been enormous growth in e-commerce on a global scale and not all this growth can be explained by the firm's financial fundamentals. The growth of e-commerce is largely a result of advances made in information communication technology (ICT) but the study of information as a key economic variable has been given much more attention by disciplines other than economics (Arrow 1996). The virtual world is one where many of the conventional constraints of physical economic processes (R&D, manufacturing, distribution and marketing) no longer apply and firms, big or small, can sell their products to anyone in the world just as easily. Arthur (1996) defines the criteria for firms subject to increasing returns as those having made high investments in information systems on their operations and are now using this information relatively cheaply. A parallel can be drawn between the present ecommerce firm and the neo-Schumpeter model of repeated innovation by a 'new theory' firm.

The development of intellectual capital for the foundation of market dominance and continuing profitability of firms has been driven by the rapid growth of intellectual capital. In spite of its growing importance, there is no absolute valuation method for intellectual capital (Dabek 1999). Introducing new intellectual products into the market has its fair share of risk, and may even be considered extremely risky in certain circumstances. Managing the project life cycle from beginning to successful commercialisation of the new product entails difficult decisions that involve risks and determine the future course of the program as well as the firm's future revenue and profitability. This means that it is far more difficult to estimate cash flows, growth and discount rates in the knowledge economy than in more traditional and stable industries.

The equity risk premium used in the discount rate should reflect what investors expect future risk premium for the business and is thus a forward looking concept. The concept of increasing returns from intellectual capital (Arthur 1996) complicates the calculation of the equity risk premium by the magnitude and timing of the increase.

2.5 Equity risk premium and valuation models: a critical review

The primary financial management function of the firm is about the optimal matching of uses and sources of corporate funds that will maximise the firm's market value: in essence, the value of the firm is estimated from the present value of its earnings over all future periods (Chew 1997). The central consideration of this postulate is the explicit recognition of the effects of all future periods. The effects include investment decisions in technology and industry and thus pose the question as to whether the principles the market adopt to valuing e-commerce stocks are appropriate and reflect all future period effects, including risk. The effects on an intellectual capital intensive business will depend on the performance of various critical success factors (Oh, Bose and Billington 2003) that decide the growth prospect of the firm.

2.6 Limitations of Current Models

The discounted cash flow models for stock valuation where future dividend are discounted at a constant rate poses three problems, the absence of historical earnings data in the vast majority of intellectual-capital intensive firms, the incidence of skewed results due to the uncertainty of the growth factor and the argument that stock prices are too volatile to be rational forecasts of future dividends discounted at a constant rate (Shiller 1981). The absence of the earnings data required by and the limitations of traditional valuation models make it imperative that alternative approaches be considered for determining the value of e-commerce stocks. Schumpeter's theory of economic development promotes the causal relation between the financial and the real sectors. The limitations of conventional approaches compel the use of real economic activities in this paper, in an integrated and analytical manner, to visualise the economic logic behind this recent development. This approach is consistent with Fama (1970, 1990, 1991), Huang and Kracaw (1984), Chen (1986, 1991) and Fama (1991), who conducted extensive study of the relation between stock market returns and fundamental economic activities.

2.7 Efficiency, Volatility and Predictability of the E-Commerce Sector

The development of intellectual capital is inherently riskier and involves commitment of valuable resources, failure could cost their investors substantial amounts of money. The implications of the EMH in ecommerce stocks relate to the efficient allocation of capital in the sense that under the EMH market financing conditions and the firm's cost of capital are optimal. The measure of volatility of the ecommerce stocks vis-à-vis other market benchmarks and statistical analysis is crucial as a further test of market efficiency for the allocation of financial resources. If the e-commerce prices do not reflect market fundamentals then resources might be misallocated and hence, volatility tests are joint test for informational efficiency. The predictability of e-commerce stock returns depends on the statistical analysis of the random walk hypothesis of the stock prices. If e-commerce stock prices were unpredictable, such test would support the rational expectation element of the EMH that forecast errors should be zero on average and uncorrelated with any information available at the time the forecast was made. The EMH emphasises that it is impossible for investors to persistently make supernormal profits.

3. A new method for estimating the risk premia in e-commerce stocks

The lack of historical data and the highly dynamic environment of the ecommerce sector make it prudent and imperative to evaluate the risk and return relation using a macro approach. Macroeconomic analysis generally focuses on changes in macroeconomic conditions as a result of changes in government policies, market structure, technology, culture and other reasons. As these factors change, expectations about the performance of a firm, industry or economy will change and affect the investment weighting given to a particular sector. The linear multifactor model (Sharpe 1964; Lintner 1965; Merton 1973; Ross 1976) developed in this study addresses the macroeconomic variables that are considered pervasive to e-commerce equity returns (Oh 2002) from an *ex post* perspective. There is a widely accepted view that the variations in expected returns are rational variations in response to market conditions (Chen 1991; Schwert 1990; Fama 1989, 1990), i.e. the expected return on a financial asset is a linear function of its betas or covariances with some systematic risk factors. The linear ecommerce multi-beta model discussed in this paper uses the method of ordinary least squares (OLS) for measuring the risk premium of e-commerce equity.

From a risk perspective, the multifactor model generalises the concept of risk under the traditional CAPM that market risk, risk that cannot be diversified away, underpins the returns of the ecommerce stocks. In this model, the market risk is measured using a series of risk factors that determine the behaviour of ecommerce returns, whilst the CAPM measures risk only relative to market return.

4. Data

The ecommerce firms in this study are selected from the population of pure-play ecommerce companies from a variety of sectors listed on the Australian Stock Exchange. The proxy for market return for the study period is calculated from the closing SP/ASX 200 index on the last trading day of the month in the period July 1999 to June 2000 obtained from the Australian Stock Exchange. The macroeconomic variables used are monthly data for the corresponding period as the stock market data, selected from various sources such as the Australian Bureau of Statistics and the Reserve Bank of Australia.

5. Econometric analysis and empirical findings

The following summarises the results obtained from our study of the e-commerce sector in Australia.

5.1 Risk-return profile of Australian e -commerce stocks

A comparison between the actual e-commerce market returns and risk (both beta and standard deviation) is presented in this section to highlight e-commerce volatility, and the results provide a characterisation of the empirical behaviour of the sampled e-commerce stocks (the market return for the period is 10.96%). The tendency of a stock to move up or down with the market is reflected in its beta coefficient -?. In Table 1, all the e-commerce sectors had positive returns except for the High Technology sector. Volatility measured against the market, represented by beta, is generally higher for most sectors with the exception of Miscellaneous Financial Services (0.57), Casino & Gaming (0.03) and High Technology sectors (-0.26). This indicates that the majority of e-commerce stock returns were more volatile than the market return in the study period. The Health & Medical Services sector had the highest beta of 19.86 and one of the lowest returns, whilst, Casino & Gaming sector had the second highest return but one of the lowest betas. From the perspective of risk-return relationship, the risk-return trade-off appears not to hold in the sample stocks in the study period.

TABLE 1 RELATIVE MARKET VOLATILITY OF SECTORS AND RISK-RETURN TRADE-OFF *

E-commerce sector	Sector beta	Sector return	Standard deviation
Health & Medical Services	19.86	0.39%	1105.33%
Miscellaneous Services	6.39	5.41%	47.04%
Retail/Retail Investment	5.22	4.20%	29.74%
Diversified Media	5.00	0.67%	28.99%
Computer & Office Services	4.93	0.07%	30.32%
Equipment & Services	4.25	26.97%	140.37%
Other Telecommunications	3.74	2.67%	21.38%
Miscellaneous Financial Services	0.57	0.44%	30.69%
Casino & Gaming	0.03	24.06%	56.33%
High Technology	-0.26	-1.26%	27.45%

Source: Oh 2002

*ranked in order of beta

Though e-commerce firms have a number of advantages over traditional firms such as lower operating costs, the global market consolidation[ii] of e-commerce stocks in early 2000 indicates a reaction to market risks and conditions faced by this sector and investors are constantly studying to see how changing technology will end up transforming the market. This confirms the general systematic risk level of the e-commerce stocks and that they move predominantly in a volatility sphere of their own, and relatively independent of the market.

The total risk associated with the e-commerce stocks is decomposed from the analysis of variance (ANOVA) of the stock return to market return regression by dissecting it into systematic and unsystematic risks. The systematic and unsystematic risk profile as measured by the market index, S&P/ASX 200 indicates that the e-commerce stocks were to a large degree subject to unsystematic risk (82%) rather than systematic risk (18%) in the study period (Oh 2002). This means that there was less of a tendency for the e-commerce stock prices to move together with the general market variability and unsystematic or firm-specific risk explains 82% of their variance. This situation can be explained by the higher return variability of the e-commerce stock portfolio; where monthly ? equals 49.82% (Appendix 1), compared to the general market; monthly ? of 3.13% (Appendix 2).

5.2 The Multivariate Regression Model - Results

This section presents the results of the tests done in estimating the e-commerce multi-beta model for Australian e-commerce stocks. The underlying hypothesis in this model is that this set of factors is important in determining and explaining the risk- return relation in e-commerce stocks. The set of factors include the relevant forces in the financial markets, international and the global financial systems the influence of which is proxied by the NASDAQ and foreign exchange rate. The limitations with this model are that time is not incorporated in the model and there may be an upward bias in the measure of expected returns (Cochrane 2001). However, the model is appropriate in that it assumes that investors are myopic (no systematic variations in the investment opportunity set) and the utility function of the investors is logarithmic. This multifactor model differs from the traditional CAPM and the market model in that both are single-factor models. The stationarity and cointegration tests conducted in this study help to detect the influence of time (i.e. the trend in the time series) and enable the study of the long-term effects of the explanatory variables on the dependent variable. On the basis of the criterion of goodness of fit, the following is estimated equation represents the e-commerce equity risk-return relationship:

$$stockret(?\overset{?}{PR})_t = -0.1900 + 0.0013?NAS_t + 0.0692?CC_t - 0.3287?FE_t$$
$$\qquad (-1.2772) \qquad (3.7657) \qquad (1.9345) \qquad (-2.1045)$$

R^2 = .6421

where:

$stockret(?\overset{?}{PR})_t$ = the returns for the e-commerce portfolio of order one in period t;
$?NAS_t$ = the risk factor - NASDAQ composite index of order one in period t;
$?CC_t$ = the risk factor - consumer confidence index of order one in period t; and
$?FE_t$ = the risk factor – AUD/US$ exchange rate of order one in period t.

All three risk factors in the estimated equation are statistically significant at the 10% significance level (t-statistics in parentheses) and indicate their pervasiveness on the e-commerce portfolio returns. While systematic risk measured by the *NAS*, *CC* and *FE* explains more than half of the variance (R^2 = 0.6421) of the e-commerce portfolio returns - PR, in the equation. Such systematic risk level is consistent with empirical study done by Drummen, Martin, Zimmermann and Heinz (1992) where systematic risk explains almost half of the variance of European stocks. The estimated model therefore provides a better measure of e-commerce portfolio return compared to the average 17% systematic risk level by the market model using the S&P/ASX 200 as the market index in this study. From an e-commerce portfolio perspective these three risk factors have the strongest influence on e-commerce stock return across all the stocks and sectors evaluated in this study. They remain statistically significant even when we use a more stringent significance level of 10% (c = 1.943). Of the three risk factors, *NAS* and *CC* have a positive correlation and *FE* has a negative correlation with the returns of the portfolio of e-commerce stocks.

5.3 Predictability

Consistent with the practice for testing market efficiency in the literature, an asymptotic analysis is used to test the weak-form EMH that information observable to the market prior to month t should not help to predict the return during the month t for the ecommerce sector return (the estimates for the EMH tests by sector are presented in Appendix 3). The weak-form EMH tests using the autocorrelation of returns data suggest the validity of the EMH for the returns of the e-commerce stocks in this study. The low R-squared of these tests supports the EMH. This indicates the tests based on (*ex-post*) real returns cannot be used to predict excess returns. De Bondt and Thaler (1985) find stocks with extreme price movements appear to have strong negative serial correlation of returns and are thus mean reverting. This would be contrary to the EMH in that it would be possible to make supernormal profits from predictability in stock prices. For the constructed e-commerce portfolio, there is no evidence of negative serial correlation except for some industry groups at the sector level. A longer time series data would be necessary to conduct a meaningful study of this volatility issue for the e-commerce stocks.

6. Portfolio Analysis

The portfolio evaluation is conducted under the Kuhn-Tucker conditions and analyses a constrained optimisation context within the context of a three-asset portfolio, being e-commerce stocks, S&P/ASX 200 (representing the market stock) and cash. The data used is from the study period. The *GAMS*[iii] portfolio evaluation program (Thompson et al. 1992) is used to test the data. The program selects the portfolios by solving a series of problems with different lambda (?), representing risk aversion, using the equation below (the risk parameter is denoted by ? and when ? is large, there is greater risk aversion).

Maximise:

$$19.95x_1 + 0.96x_2 + x_3 - ?(0.22x_1^2 + .0009x_1x_2 + .0019x_2x_1 + .0009x_2^2)$$

subject to:

$$14.66x_1 + 7.47x_2 + x_3 = \$1.394$$
$$x_1, x_2, x_3 = 0$$

The results of a series of parametric tests for various values of ? are shown in Table 3.

TABLE 3 OPTIMAL SOLUTION [iv]

??	e-Stock*	Mkt Stock*	Cash*	Expectation	Variance
0.0005	31.62	0	1,393,972	41.45	9,836
0.0006	26.34	0	1,393,978	34.54	6,831
0.0007	22.59	0	1,393,981	29.61	5,018
0.0008	19.76	0	1,393,984	25.91	3,842
0.0009	17.57	0	1,393,986	23.03	3,036
0.0010	15.81	0	1,393,988	20.73	2,459
0.0015	10.55	0	1,393,993	13.82	1,093
0.0020	7.91	0	1,393,996	10.36	615

Source: Oh 2002
*$'000.

The general conclusion about market stock drawn from this parametric test is that it would not be a portfolio choice for all risk levels. This is largely due to its insignificant impact, in a portfolio context, in terms of the stock's relatively small expected return (0.96%) in relation to its risk (standard deviation = 3%). When risk aversion is less (i.e. ? is small) there is a tendency to purchase more of the riskier e-commerce stocks. When risk aversion is high (i.e. ? is large), the preference would be to hold more cash rather than the less risky market-stock, as the trade-off between the risk-return of the market-stock would tend to favour holding cash. This optimisation test supports the degree of volatility, i.e. riskiness, of ecommerce stocks as manifested by the small amount allocated as an investment choice in this highly volatile asset. When risk aversion is at its lowest in the test (i.e. ? = 0.0005), the amount invested in e-commerce stocks is only $31,620 (or 0.000023%) out of the available investment sum of $1.394 billion during the study period. This suggests that the investor would rather choose to hold cash than to invest substantially in any of the two stocks when the e-commerce stock is too risky and volatile and the market-stock's return is too low for its risk level to be considered an advantage to holding cash. Conversely, the analysis suggests that the investor has to have relatively low risk aversion to remain invested in e-commerce stock.

In a three-asset portfolio selection scenario consisting of one risk-free asset, the e-commerce stock becomes a portfolio choice in preference to the market stock. The trade-off in portfolio choice is between the riskless asset and the highly volatile e-commerce stock. The relevant optimal portfolios would consist of a very small proportion in e-commerce stock and mainly in cash. From table 7.1, with increasing proportion of e-commerce stock in the optimal portfolios, from ? = 0.0020 to ? = 0.0005, we are able to see a four-fold increase in expected return but a sixteen-fold increase in portfolio risk. This confirms the earlier results that the inclusion of e-commerce stock in a portfolio leads to a disproportionate increase in portfolio risk.

7. Conclusion

The volatility of ecommerce stock returns appears to be consistent in terms of: the yield spreads, betas and standard deviations of the individual stocks; the systematic and unsystematic risk profile; and the EMH tests of the class of stocks examined in this study. Compared to the market, the yield spreads are excessively wide, while the standard deviations and betas are relatively higher. The high degree of unsystematic risk profile together with the weak form efficiency of the stocks suggests a higher level of industry-specific information turnover reflecting the evolving nature and nascent stage of the e-commerce industry. This infers that e-commerce prices (hence returns) that alter by large amounts in the months of this study reflect the rapid changes in fundamentals of the industry. These changes may represent the opportunity sets for ecommerce firms and industry or more general structural market reform in response to ICT related developments. It is probably difficult at this stage to gauge whether the e-commerce market is excessively volatile relative to the general market, due to the lack of comparative and long-horizon earnings performance data for e-commerce firms, which could provide a yardstick against which to compare volatilities. The following sets out the more discernible risk characteristics of Australian e-commerce stocks.

7.1 Risk and valuation of e-commerce equity

The multifactor modelling approach is used in this study to explain the return-generating mechanism of stocks consistent with the various theories that have been advanced (i.e. Sharpe 1964; Lintner 1965b; Mossin 1966; Ross 1976) and at the heart of these pricing theories is the notion that one or more pervasive factors are dominant source of covariation among asset returns. The systematic risk measured by the *?NAS*, *?CC* and *?FE* factors in the estimated AEMM model, explains more than half of the variance of the e-commerce portfolio return *?PR*. The parameters in our regression of e-commerce stock returns, based on a set of predictive variables, appear to be weak when described by usual statistical measures. This is first evidenced by the low estimated systematic risk for ecommerce stocks that suggests e-commerce stocks to be in a unique universe. The use of a higher significance level for testing the null hypothesis for correlation between the dependent and the explanatory variables is another example. This suggests a weaker predictive quality for the variables. Nevertheless the selected pervasive factors do tend to explain a substantial part of the e-commerce portfolio return with an R^2 of 64.2% for the estimated three-factor model using the first difference data of the time series.

7.2 Systematic and Unsystematic Risks

The excessive volatility against market return of the e-commerce stock returns is attributed to the high level of unsystematic risk (low R^2) in the stocks as discovered in the regression analyses using the market model. The low compliance of e-commerce return to the market return reflects emphasis on different economic fundamentals in stock valuation. It appears doubtful that information for equity valuation can be used consistently and therefore rationally in the absence of an agreement (or general understanding) on the economic fundamentals that determine e-commerce valuation –therefore suggesting a strong presence of event effects in e-commerce stock prices in the market.

As the business activity of e-commerce firms becomes more established and stabilised, the level of unsystematic risk is expected to decrease while the riskiness of the stock is expected to reflect more the systematic risk or market risk. This can be explained by the fact that a firm's earnings become more stable and predictable as its business matures and it carves itself a niche in the market. It is consequently able to set clear objectives and direction for future growth. What then happens is that ecommerce firms become more like the traditional firms in the market that are sensitive and subject to market fundamentals. This characteristic is consistent with the mean reverting behaviour of stock returns, that is, higher than average returns are followed by lower returns in the future (Fama and French 1988a; Poterba and Summers 1988). Initial above average e-commerce stocks could be due to the low information content of a relatively new class of stock in a euphoric new market which as time progresses, and more information about the ecommerce firm, industry and market becomes available and the industry establishes itself, the stock returns will adjust accordingly. In their studies, Fama and French (1988a) and Poterba and Summers (1988) find mean reversion in stock return over long horizons, in excess of 18 months. The 'normalisation' or mean reversion of the ecommerce stocks is probably going to take longer as e-commerce is still evolving with the Internet, and to become fully developed and universally accepted as an established market structure, may still be a while yet. The wide spread in actual return and the substantial difference compared to the required rate of return for the ecommerce stocks suggest the market for this class of stocks has not reached equilibrium.

7.3 Portfolio risk

The portfolio study suggests a high degree of risk aversion towards the highly volatile e-commerce stocks. The portfolio-choice analysis of the three-asset portfolio comprising of the e-commerce stock, market stock and cash, indicate that the efficient portfolios under different risk aversions would tend to minimise the holding of e-commerce stock. The study on financial optimisation here is confined strictly to the prevailing market conditions (i.e. pertaining to e-commerce stock return, risk-free rate and market index return) during the study period and within the context of the specified risk parameters. This portfolio position is not expected to remain static given the changing market conditions and investor's risk profile.

7.4 Risk and cost of capital

Our analysis highlights several important implications in relation to the cost of capital issue and e-commerce investments. First, the risk premia we have identified are extremely important for determining the hurdle rate on new e-commerce investments in that they represent the levels of compensation for the taking risk in ecommerce equity investment. These risk premia are estimates based on real economic factors and therefore fundamentally and explicitly incorporate the relevant market risks. Second, as investments in the e-commerce sector are riskier projects, they rely more on equity capital than debt financing and always face a higher cost of capital than debt financed investments. This implies that a greater emphasis is placed on the effective measurement of the cost of equity capital vis-à-vis e-commerce investment.

References

Contact the author for a list of references

End Notes

[i] Oversubsciption of Hong Kong's Tom.com by HK$144 billion and MelbourneIT.com are recent evidence of this phenomenon.

[ii] April 2000 when the market index dipped caused predominantly due to the fall of stocks in the e-commerce sector.

[iii] General Algebriac Modelling System (GAMS) software.

[iv] Summarised from GAMS output (Oh 2002).

Global Strategy Against Financial Risk

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Abstract

The aim of this highly polemical and current issue is to provide professionals with international vision on the new business culture. We propose that business ethics is the most important foundation of the business culture and requires professionals to commit themselves to the course of ethical actions. Under these conditions, not only are the business professionals expected to detect but also to reject illegal financial operations.

In the worldwide global environment new protagonists, such as new business, religions and highly organized criminal groups are appearing on stage. Therefore, it is clear that we are facing a rising rate of social unpredictability, which have the potential to lead to faradism and invention of new terrorism tactics for individuals and institutions. Thus, the concept of security, and security itself, must be reconsidered and reevaluated.

The Role of International Organizations

Financial stability and economic prosperity are threatened by money laundering and by finance for terrorism. All of which is aggravated by crimes committed in order to obtain such money.

When criminals or terrorists use an institution in an unnoticed manner, this harms the industry's image and reputation. And if some company managers are in collaboration with those criminals to launder funds or to send finance for terrorism, the harm can be even greater and can even draw the company to its closure.

After the September 11 attack, the scandals due to the ENRON and WorldCom bankruptcies as well as others, and to the detection in several countries of important money launderers, when general public senses that an institution is prone or vulnerable to become a money launderer company, it simply stops investing in it.

The most serious known consequences are those where a financial institution is controlled by criminals, since in these cases the whole integrity and operations of the financial system are engaged.

Money laundering consists in the operation of transforming illegal money from illicit activities into usable forms. This money is disguised from its illegal origins and introduced into the financial system and then hidden (or laundered) through a great variety of financial transactions and vehicles both domestic and international, which in the end will be invested in legal financial products and assets. All this procedure is aggravated by the speed of electronic transactions worldwide; in other words we can say that money laundering is intrinsically global.

Financial terrorism can be defined as the processing of a property of some source (maybe legitimate) to be used in the finance of terrorist activities that have been or will be committed, by using the same techniques as those for money laundering.

Several terrorist organizations are known to finance their activities with means that have no connection with criminal procedures. These organizations are much harder to detect than money launders. It may be possible that the only violation they could be accused of is that of a machination or a conspiracy to commit an act of terrorism.

The amount of money needed to finance terrorism is much less than the amounts of money laundered daily by drug dealers. According to some specialists, the amount of money required for the September 11 attack to the World Trade Center and on the Pentagon was approximately less than one million dollars.

The international community has been working to fight against money laundering and financing for terrorism. After the September 11 attack these efforts have doubled, countermeasures have focused on a better supervision, a better regulation has been proposed as well as a timely detection of critical information gaps through borders. The effectiveness of such battle relies on the creation of a reasonable countermeasure system in the global field. Several conventions and protocols (UN, OECD, ASO and APEC) have agreed to develop the following commitments at a global scale:

1. To penalize the laundering of money derived from illegal activities.
2. To design and establish regulations and surveillance for financial institutions and related organizations.
3. Exchanging of experts.
4. To use state of the art technology.
5. To develop instruments of international cooperation for the restrictive application of the law.
6. To guarantee information cooperation and exchange of such in the international field.
7. To establish financial intelligence organizations in each country, to perform the analysis and promotion of specialized information.
8. To supervise real and virtual trans-border movements.

Both the International Monetary Fund (IMF) as the World Bank (WB) in 2001 have evaluated the way in which actions have been taken to stop money laundering and finance for terrorism within their areas of specialization and responsibility, and have arrived to the conclusion that the greatest responsibility falls on governments, financial institutions and citizens of each and every country.

Since then, the IMF has focused on the integrity and stability of the international financial system and is working in close collaboration with the Financial Action Task Force (FACT) and together with the World Bank in the setting of international standards.

Financial World and Globalization

We Mexicans have not cleared anymore how to interpret the past, and much less what to expect from the future. Since the future is not necessarily related to the idea of progress. Under certain circumstances change can be interpreted as something with no direction, undetermined, because people feel uncertain not only because of the present crisis, but due to the rapidness of change itself and the complexity of the new globalize world. In times of turbulence, luck plays a key role in the determination of the future.

As States, individuals and groups become global actors, insecurity and vulnerability grow and two fundamental questions about globalization arise: What is it? And, is it inevitable?

To the first question we can answer that globalization is a whole formed by technical elements such as mobile telephones, Internet, satellites, personal computers, television, radio, cassettes, etc. which are available for States, individuals and groups. However, the behavior of such actors is guided by egoism and ideology, not by humanitarian reasons. Such behavior is opposite to that of a globalize vision based on an illustrated utopia (scientific, rational and universal) if not so; ask the millions of poor people, whose number is increasing day by day in our planet.

To the second question we can answer that the scope of globalization is still limited due to the fact that civil societies are international yet not globalize, thus, a trust towards the formation of a World State seems less possible each day. Globalization is both partial and fragile. If it is so, we should all ask ourselves how our global world could be made more inhabitable.

Globalization contains internal contradictions which we will briefly state: 1) International and transnational cooperation is necessary so that globalization cannot be undermined by inequalities. 2) States and actors must operate in an altruist manner in that concerning their long-term interests.

Globalize institutions are atomized and are not large enough, foreign investment grows according to bilateral agreements and there is very little improvement in environmental protection matters. Globalization forces us to decide between the competitions levels of economy of the level of protection of social security. We are living in a world joined by technology but separated from the perspective of collective solidarity and ethical behavior.

Criminal organizations have modernized themselves up to the point of becoming a global organized structure. In the past, their activities were very specific and focused in a particular location. Nowadays they have found a way to fragment their illicit products and services as well as to launder money by electronic means at an every day higher speeds, which in turn gives them the possibility of corrupting individuals and groups that belong to those institutions devoted to their combat.

We must add that the globalize world now has new actors such as: big enterprises, religions, criminal cartels and globalize criminal organizations. The only thing we know is that we are heading to a point of high unpredictability within the social field, of high uncertainty that will cause the finalization of some people and institutions and the birth of new forms of terrorism which will force us to rethink our concept about security.

These criminal organizations endanger the security of democratic institutions and the sole viable option to stand up against them in international cooperation. This means that each nation will be forced to make a coordinated effort to establish new legal frameworks, better and larger education and training programs as well as the needed tools to effectively prevent and combat the works of such criminal organizations.

Establishment of Business Ethics in Universities

In 1960 the business community of the USA started taking into consideration business ethics and companies began to establish their own ethics codes. In the nineties a great number of enterprises had their own codes. By 1991 the federal Penal Code of the USA stated that if a company accused of breaking regulations had indeed an ethics and conduct code, then any court verdict would be "softened" to a sentence and fines.

Most of the companies understood this and devoted themselves to the establishment of ethics and conduct codes and few were actually caught without a well elaborate ethics code. However many or these companies did not pay much attention to their codes or used it only to have good public relations, and only very few of them really stuck to and followed it.

In April 1995, The Economist published that according to a research 60% of companies in the USA had ethics codes, because they had discovered that is was useful to have an ethical behavior. The research mentioned the most of these companies had a specific department for ethics and some of them even had an ombudsman.

If this is true, why did the corporative cataclysm started by ENRON and WorldCom occur and was followed by a legion of frauds that caused the fall of the stock exchange market where loss was greater than that of the Black Tuesday in 1929?

What failed? For some, neo-liberalism and its markets know nothing about ethics and besides the objective of companies are to look for the maximization of the immediate profit and forget to praise impeccable conduct and ethical persons.

For others, the failure resides in the increase of the corruption rate in the world of big enterprises, as well as the severe deficiencies or absences in the supervision and control mechanisms on behalf of the State. The main question in that moment was to increase the efficiency of surveillance and control and the resetting and rewriting of ethics and transparency or in such a case, do nothing. From this point on, the international consultant enterprise Price Waterhouse Coopers developed three future scenarios about the different results for corruption and fraud treatment as follows:

Scenario No. 1: **Do Nothing.**

1. Nothing is done against corruption, and complete chaos overcomes.
2. Each country follows its own accounting principles.
3. No country adheres to global principles.
4. Nobody trusts anything.
5. Capital flow is paralyzed worldwide.
6. Auditing ceases to have relevance.

7. World becomes chaos.

Scenario No.2: **An Overreaction is caused.**

1. There is an overreaction in regulations: (As it is starting in the USA with the Sarbanes-Oxley Act).
2. Everything is extremely controlled by the governments.
3. Bureaucracy increases which delays taking of decisions.
4. Nobody is interested in auditing companies.
5. Government auditing offices abuse of their authority to submit companies under their control.
6. Bureaucracy grows in an exponential way creating social anomy.

Scenario No. 3: **Everybody Searches for Business Transparency.**

1. Principles and Tools are applied to seek for business transparency.
2. Everybody participates in its implementation.
3. Everybody feels responsible.
4. Companies have honorable staff.
5. Transparency is created within each one of the chain links of financial business information.

Reality gave us a double answer. On one hand scenario No. 3 was adopted, and on the other hand, regulations, domestic, and international principles to regulate and evaluate business systems were improved. Unfortunately short term vision, the search for immediate profits regardless of the means to attain such profits prevents an effective implementation of the necessary control and supervision to avoid frauds, hoax, and traps.

All of this forces us to re-elaborate the ethical systems through education and training at all levels within an organization. It is the only solution to prevent us from ending up in a chaotic scenario or under the influence of an Orwellian repressive bureaucratic apparatus.

Business ethics can be defined today as a business strategy in which compromises and responsibilities are adopted together with the key audience of a company (clients, employees, stockholders, suppliers, creditors, community and government), by obtaining at the same time economical benefits. It is necessary to clarify that a reasonable effort has to be done to stand apart from the tendency to justify business ethics just because they are useful, without understanding that ethics are inherent to all human activities. Now, considering it from the point of view of maturity as business methodology, we can say that it is now where quality was 20 years ago.

When faced to global competition, values, integrity, and ethics have become a very important patrimony. However, globalization affects the execution of ethics due to cultural differences and to work practices in the different business fields.

It is the task of our Universities to be the leaders of a movement where ethics are no longer an elective academic subject just because it is not a useful matter for the professional's performance. If social life has deteriorated so much, it is greatly because a lot of people regard and deal ethical and moral issues in a slanting, condescending, indifferent, and cowardly manner if not stupid. From now on ethics and integrity must be the basis to improve the performance of both companies and society. Social responsibility and ethics must be the axis of all business and social actions.

We need new programs, new courses, new diplomas, and postgraduate studies as well as the ethical intervention at all levels and in all university study programs. A great amount of new knowledge, new themes and new approaches are coming up that will enhance our university curricula. We can see some examples in Table No. 1.

TABLE 1

THEMES OF ETHICS	THEMES OF ETHICS	THEMES OF ETHICS
1. Business ethics and electronic	5. Ethics of the relations client-	9. Ethics and business

business ethics.	suppliers.	transparency models.
2. Theory of ethical decisions.	6. Ethic interaction with the communication media.	10. Compared Codes of professional ethics.
3. Ethical auditing in companies.	7. Social balance ethics of the companies.	11. Ethics and conduct codes.
4. Ethics, uncertainty and business risk.	8. Ethics, corporate conduct and professional conduct.	12. Ethics in the market and free competence.

We must teach our university student “that in the end we will always find ourselves with the ethical responsibility and that we must avoid moral hypocrisy and their representatives since they are the ones that cause social stagnation”.

To talk about ethics without having an idea of where things may lead is not only vane but useless, without the ability to know the possible future their can be is neither ethics nor progress. A concept of the world and of man that cannot be translated into a direction in life is inefficient. Every situation and condition, every institution and every action that affects quality of life and man’s possibilities for his development falls within the domain of ethics.

The ethical net consists of the individual’s capacity to see the contradictions between what he is and how he lives, and what he could become and how he could live. The core of ethics is the need for codes and norms that allow regulation of human relations and the assurance of a stability of society.

Universities are the keepers of knowledge and wisdom, they guard the future, and they are in charge of preparing men that can extend their ethical judgments to larger grounds of the human experience and conduct. I invite all of those present here to revalue ethics and give it a new impulse in your own Universities, to make it grow not only in a quantitative but in a qualitative way (in teaching and research), since adapting oneself to life’s changing conditions confers moral codes and ethical theories their biological and socially evolved value.

We are now at the moment in which we need to make an effort to create an ethical revolution that goes ahead of the rest of the world revolutions.

Towards a New Corporate Culture

All cultural activity is conscious and is bound to progress; therefore it has an ethical signification: man’s destiny is to become the creator of cultural values. Every cultural work must be good and every good action is a cultural realization; in this similarity we expose the relation of ethics and culture.

Culture can be defined as ways of living and creativity patterns. Every human organization has a culture, which in some cases is fragmented and in others, it is strong and cohesive. Be it strong or weak, culture exerts a powerful influence over organizational structure. Culture influences everything, from personal motivation and taking of decisions to social behavior.

We are heading towards a new culture, local and planet wide, a culture prone to legality, institutional transparency, personal integrity, ethical conduct, accounting for and high social responsibility if we wish to survive. It seems that we are entering a very dangerous world, where companies in order to survive and develop in a solid way, apart from being effective, have to be honest and transparent.

The Dangers of Money Laundering in Financial Institutions

Much has been said about the problems that every financial institution can face with its staff, executives, and directives when operations with resources of illicit origin are detected. However, the lack of consciousness of certain areas of such enterprises, do not have the sensitivity of the problems in which they may be involved in because they do not know the final objective of battles against illegal operations.

The issue we are presenting now has to do with High Risk because it affects the security and calm of the board of directors of many financial institutions who can in turn be affected in legal and economic ways, and with great moral harm for the owners of the money since they were not attentive enough to the money laundering problem.

This is a calling to the members and directors of universities to establish an approach through the knowledge of the money laundering issue, and to find different ways to participate in the conformation of specialty studies, diplomas, forum creation, and integration of expert committees to be part of the solutions that are required in the different areas of our public institutions for the battle against this crime.

It is also a calling to high level investors that trust their money to executives and high rank officials who are not trained in the Prevention and Detection of Money Laundering, who have no specialization studies or have no certification that may guarantee an institutional transparency as well as a personal and moral tranquility.

Globalization has allowed the Mexican financial System to increase its scope in international business, as well as the incorporation of new banking and financial services, granting in such a way the automatic handling of huge amounts of money made in a great number of direct (origin) and indirect (transit) operations. These operations are used by money laundering professionals to infiltrate within domestic and international investments, which in turn, because of their great volume cannot be identified by an executive, who on top of everything does not have a specialized training to do so.

Capital infiltrations may have several forms within the operation of money laundering. They can be infiltrated in small amounts with frequent and permanent quantities from enterprises established as *Laundering Fronts* that allow these professionals to have an economic and productive façade legally constituted for the development of its main illegal activity. However, in Mexico still, in spite of the efforts made in the fulfillment area, the view of our executives does not fully understand the Fundamental Principle of Financial Inconsistency as a vital tool to star specializing in this subject.

Another way to infiltrate great capitals for money laundering is administrative negligence, which resides in procedures made by staff lacking knowledge in financial prevention. These situations enable us to say that there is a large possibility that processes have enormous deficiencies and that these deficiencies are very well established, and the lack of integration of specific defense mechanisms that protect the institution's integrity of that of its stockholders in a permanent way by establishing a prevention and protection culture. All of this enables the attaining of financial and contra-analysis elements which may allow us to *identify investors with capitals of doubtful origin and who do not have a financial transparency* within the operations they perform.

The lack of accounting for financial statements on behalf of the directors is solely an honorable and corporate ethics compromise that must be stated in the organizational politics, systems, and procedures. High CEOs monthly inform of the institutional activities to the board of directors, yet there must be confidence about the kind of information, which stockholders receive through the establishment of quality in the information with elements such as opportunity, reality and depth which can guarantee transparency and tranquility for them. The Board, who in turn must determine the guidelines for institutional fulfillment and protection including some communication with the corresponding authorities, must set the norms for the truthfulness of the information.

The Board of Directors must emphasize in the incorporation of staff in their financial business, since the lack of filters of high selectivity in the hiring of personnel can only be an open door for the infiltration of illegal operations that can endanger the institution's integrity. This and the corruption of officials is one of the most successful activities for money laundering, hence prevention actions in this aspect must be increased.

Lack of Financial Transparency for Domestic and International Investors

Year plans of financial growth developed under a directive planning may be implemented, as part of an institutional compromise in fulfillment of the trust placed in them by the stockholder group. Yet this can also be violated by the breach of the established plans due to the director's lack of results. But part of this transparency becomes an obligation to present to the authorities, investors, and clients the goals achieved as well as the deviations from the purposes of good results.

The integration of politics in the corporate and financial report supply for the stockholders group, one of the tasks of the fulfillment area, will allow information to flow in a transparent way and with the integrity of those who develop this kind of information. The opportunity to establish in a very near future a manual of financial ethics in which quality and honesty of information are included must be pointed out.

One of the red alert points for stockholders is the constant reports, surveillance, and audits established by authorities, as well as the observations about operation practices in the institution. Attention must be set in all those parameters that point out to the surveillance organisms about the different dispositions, requirements and internal auditing results performed by the areas in charge.

Institutional Negligence

There are financial administrations that only develop general fulfillment procedures, which are intended to cover a minimum of the established dispositions arguing high costs of implementation of these kinds of programs. However, the development and setting of internal control procedures on fulfillment place in high-risk institutional survival just to please personal interests and no integrity. The development of plans with an institutional conservation and protection vision as a long-term permanent investment strategy allows the required and internationally established business transparency.

To delay the corporate and institutional setting of an ethics code may lead to huge voids of honesty, integrity, responsibility, and surveillance in the development of integral processes of financial operations, as well as to the lack of permanent commitment of executives and staff of the institution. Institutions are formed and directed by men, men who require action limits and truthfulness in their performance.

New rules, new regulations and dispositions will continue to be incorporated in a permanent way, and these will again cause a change in politics, procedures, and systems. Therefore it is necessary to establish in Mexico a validation system of the internal control processes which will allow the guarantee of the confidence in the implementation of the prevention systems which will operate within standard parameters but most of all, of the security of those who are undertaking such processes. Thus, it is important to stand out the Certification of Processes, which in other continents is providing confidence to the investors, financial stockholders, and institutions in general.

It is a top priority to create our own certification parameters in co-participation with authorities and regulation organisms. This is a vital and opportunely participation which can be chained to other areas of fulfillment.

It is clear that each financial organism trains its staff according to its resources and characteristics, and in some cases, the little or no supervision in the integration of training can only lead to institutional mistrust (for example in branch offices and/or sale force) to the point of inhibiting the sale of products and services because of the fear caused by the unawareness of their responsibilities. However, concerning money laundering, finance for terrorism and institutional transparency there is only one direction and all efforts must be joined to standardize specialized training, as well as the training and specialization of prevention and fulfillment units, all headed to a studies certification. Therefore, this specialized subject requires specialized consultants and counselors that will permit to order and reorient efforts to attain the confidence and guaranty of having highly prepared crews.

Collateral Effects

?? Vulnerability to financial tricks, frauds, scams, money laundering, infiltration of capitals of doubtful origin, and tax evasion.
?? Judicial investigation processes.
?? Total or partial loss of domestic and foreign investment.

- ?? Freezing of financial accounts and operational systems.
- ?? International public damage of the corporate and institutional group image.
- ?? Involvement and relation with illegal situations and felonies.
- ?? Companies ranked with low levels of corporate integrity by authorities and certain sectors.
- ?? Trust and credibility loss on behalf of clients, stockholders and future investors.
- ?? Total loss of international business opportunities.
- ?? Low or no level of repurchase or stock response from domestic and foreign investors.
- ?? Tendency to merging or disappearance from the domestic and foreign markets.

Strategies for Corporate Prevention

1. The passing from a restrictive system to a preventive one that will allow the financial anticipation and protection.
2. Integral collaboration with domestic and foreign authorities in accordance to their suggestions.
3. Establishment of a permanent program of institutional surveillance that will allow the validation of such supervision, the internal control processes with stockholders and authorities.
4. Institutional diagnosis over prevention internal control processes that will enable to measure and establish a level of financial risk.
5. Konklave 1. Support instrument for the corporate institution and authorities that enables the establishment and maintenance of politics, norms, processes, systems, fulfillment and training in virtue of the measurement of financial risk.
6. Verification of control processes for the prevention and detection of operations with illicit resources.
7. To count with specialized consulting firms with recognition from authorities in this subject, which will validate internal control processes of corporate protection.
8. Certification of internal control processes that will guarantee above all the tranquility of the corporation.
9. Periodical training in financial risk and institutional transparency for partners, stockholders, and investors of financial institutions.
10. Specialized training and qualification programs, which are registered in institutions, and ruling organisms that allow a confirmation of structures and reliable plans mainly for the prevention and fulfillment areas.
11. Permanent design and revision of the Ethics Code and its fulfillment at an institutional and corporate level.
12. Promotion of internal control audits from the ruling authorities with the application of sanctions in case of non-fulfillment and its recommendations.

Legal Framework about the Prevention of Money Laundering

The dangers of high financial risk are the practice of laundering of illicit resources that are generally developed by the triangulation of operations among different countries and continents, to make identification of real sources of such recycled resources more complicated. There we can see the relevance of forums like this one whose objective is to value the advances and challenges that must be faced regarding this subject in order to educate the next generations in the prevention culture of such crimes.

Mexico has subscribed international agreements and treaties to fight against this type of operations with resources of illicit origin and has a place as a permanent member with full rights acquired on June 21st, 2000, within the organism named FACT (Financial Action Task Force), which proposed 40 recommendations to which eight were added about finance for terrorism, related to money laundering which have been based on the following principles.

1. Qualify as a serious crime money laundering, i.e. the performance of any financial operation with the profit a crime;
2. To allow the confiscation of property;
3. Identify the clients and maintain the corresponding documentation;
4. Implement internal controls within financial institutions and make these report any suspicious activity to the authorities, and;
5. To maintain from the authorities a close supervision and control of financial institutions.

Mexican authorities have issued a series of legal dispositions to fight against the performing of financial operations with sources coming from crimes that include the making of activities with money, rights, or properties of any nature that come from or represent the product of an illicit activity, moreover, several normativities have been issued to implement the principles of FACT, such as the internal control and report of financial institutions regarding relevant unusual or concerning activities among others.

After Mexico became a member of the FACT, the Ministry of Treasury (SHCP) issued in November 2000, some modifications to the General Character Dispositions in which it established that credit institutions must identify persons that perform multiple or fragmented operations that added up are equal or exceed an amount of $10,000 US Dlls. In their equivalent in Mexican pesos or in any other legal currency, independent of the obligation of identifying their clients or third parties when they are performing individual operations in any monetary instrument starting from the above mentioned amount.

All of this is a consequence of the reforms passed to the dispositions referred to in article 115 of the Credit Institutions Law, which implies the necessary modifications in the corresponding Operation Manuals in order to customize its internal procedures and politics to prevent, detect, and report operations with resources of probable illicit origin that might be detected.

Proposals:

Significant Changes in Professional Information

Caused by the regrettable events in New York and Washington D.C. on September 11, 2001, the Mexican government has redoubled efforts to adhere to international normativity agreements and treaties regarding combat to terrorism, psychotropic substances and institutional transparency.

Present agreement define the actions that different governments must adopt to attack this problems, in the case of Mexico, the Ministry of Treasury (SHCP) is developing because it is the main governmental dependency that regulates financial and tax operations in the country.

From the events of September 11, the Security Council of United Nations established some resolutions that force country members to:

- ?? To secure and confiscate properties of persons directly related to terrorist acts.
- ?? To spread lists of members of terrorists groups currently operating in the world to determine the existence of these within our financial system.

In Mexico, money laundering is a crime considered serious in Mexican legislation and we must remember that it is originally born as a tax crime to be later transformed into a federal crime in accordance to the recommendation of the FACT.

We must state the difference between money laundering and tax evasion crimes according to that established by the FACT. Since the first one is derived from the performance of operations with resources of illicit activities, and the second one is derived from the non-fulfillment of obligations by taxpayers, they are punished on a separate basis. These are two different but related crimes; and strangely Money Laundering necessarily reunites all the elements of tax evasion.

Crimes such as money laundering and terrorism are considered in our Federal Penal Code as serious. However, the finance for terrorism crime has not yet been classified as serious but actions are being taken for its incorporation to such Code.

We can take a look at the following eight recommendations established by the FACT about finance for terrorism:

I. Ratification and execution of the United Nations;
II. Classification of finance for terrorism and money laundering;
III. Freezing and confiscation of terrorists assets;
IV. Report of suspicious transactions related to terrorism;
V. International cooperation;
VI. Alternative systems of fund sending;
VII. Cable transference; and
VIII. Non-profit organizations.

Future medium and long-term actions about regulation of non-financial institutions are currently in discussion on different international forums. In this sense, the role played by accountants, lawyers, notary publics, public brokers, real estate enterprises, and currency exchange centers are the main discussion point, since they are not regulated in the present moment. Therefore the intention is to look for an integral opinion among professionals and authorities to strengthen supervision and surveillance on financial operations that are made between institutions, countries, and continents.

Conclusions:

The Importance of the Participation of Universities

Participation of Universities in the themes we have talked about is very significant, because they represent the main vehicle in the achievement of an objective culture realization in these and other themes, as well as to overcome the deficiencies presented by our professional market at the time of problem solving. Such problems are not exclusive of a certain society group, but they touch and affect all the population of our great country, Mexico.

If we do not act within the academia field, we could loose the opportunities to establish mechanisms and strategies to give the young population in our country elements to solve specific problems. Indeed we could dangerously increase social, professional, governmental, and corporate chaos.

To end, I wish to express that what we have stated here it not something trivial but only the principles and norms to which we should submit ourselves to live our lives. This is not my saying Plato expressed it in his work The Republic more than 2,300 years ago.

Thank you very much.

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Political Risks and Foreign Investment

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Abstract

This paper presents the impact of the political and economic environment of Mexico on the operations of the multinational corporations. The ideas presented here are the result of a research that was done using six major British multinationals operating in the food and beverages industry, namely, Allied Domecq, Cadbury Schweppes, Grand Metropolitan, Guinness, Tate & Lyle and Unilever. The particular events to which these companies were exposed are the political and economic risks that occurred in 1994. The findings show that politics and economics are intertwined and in Political Risk Analysis they have to be treated together. It is also clear that the characteristics of each company will shape the impact of these risks on their operations and on the design of their response. Multinationals are not interested in the politics of a country in which they are operating as long as the conditions exist for profitable operation.

Introduction

In this research, a single industry is chosen but the companies operate in different sub-industries within that sector; this will help to show the complexity and specificity of political-economic risk. All the companies were exposed to the same adversities but the impact of these events and the multinational corporations (MNCs) reactions might be different because of the characteristics of each company. This research analyses both the nature of the MNC and the environment of the country to find out why multinationals react the way they do. This study is concerned with the political-economic risks that took place in 1994 and attempts to provide a more exact explanation and a better understanding of the performance of these MNCs after 1994.

In this study the responses of the MNCs to that political-economic risk and the differences in the negative impact of the risk on their operations will also be studied. This study intends to look at the impact that the political and economic environment in Mexico has had on a group of companies operating in the same industry. The companies chosen are major British MNCs operating worldwide in the food and beverages industry. They are Allied Domecq, operating mainly in wines and spirits, through Casa Pedro Domecq; Cadbury Schweppes, which owns a soft drinks company, Cadbury Bebidas; Grand Metropolitan, with a share in a spirits and wine company, Casa Cuervo; Guinness, which has a wholly owned subsidiary, United Distillers de Mexico; Tate & Lyle, which has a large share in a sugar refining company, Azúcar Grupo Sáenz and Unilever, which has different companies in the fast consumer goods sector operating under the corporate entity of Unilever Mexico. It is important to stress that we are concerned only with their direct investments and not with other operations that they have in Mexico, such as franchises or joint ventures. It is not a unified sample of companies, since each one specialises in a different sub-industry. The differences among the companies will help us to understand the reactions of these companies to the same events.

This sample has several characteristics. First, with the exception of Unilever, all the Mexican companies were acquired by the British parent company after 1990. Second, not all the acquisitions were made with the objective of having a presence in the Mexican market; two of them resulted from the global strategy of the MNC. Third, the six companies have a different pattern of ownership and this will help us to see whether this ownership affects the impact of the events on the MNCs and on the design of their response.

The purpose of studying the period between 1990 and 1998 and using 1994 as the centre of the analysis is because, even if the neoliberalist reforms started in the middle of the 1980s, it was in 1988, with the arrival of President Carlos Salinas de Gortari, that measures were speeded up. Mexico began to be perceived by the outside world as a successful economy which was developing rapidly. It was during these years, 1990 to 1998, that most of the companies used in this study became interested in Mexico. The hope that Mexico was becoming a developed country was proved wrong in 1994. The events starting in January of that year, which culminated in the devaluation in December, reflected the inequalities of the Mexican society, the difficulties of its economy and the contradiction of a political system which did not seem to be responding to the new demands of the economic programme.

These events are going to be evaluated in a number of ways. First, we will look at the past performance of the MNCs and the way they have reacted to previous conditions at a global level. Here the objective is to disentangle their strategy in order to understand where they place their investments. Second, the study relies on the qualitative data obtained through interviews, both in Mexico and the UK. The fieldwork included a total of 22 personal interviews conducted with senior managers of the parent and subsidiary companies, with Mexican and British government officials and with two consultancy groups

Political-Economic Risk

A definition of political risk is: "Contingencies arising from the political environment, not political events and processes per se. Political events must be regarded as cause, not effect, and hence they are of concern only in so far as they affect managerial strategy." [1] Another author states: "Political risk in international business exists, 1) when discontinuities occur in the business environment, 2) when they are difficult to anticipate and 3) when they result from political change." [2] One consultant defines political risk as: "Any situation or development that can affect a business venture in any way." [3] The obvious examples are political instability, military *coup* and problems arising from elections. Political risk goes further; it is anything that can affect business, which could be an economic downturn or devaluation, as in 1994 in Mexico, but also operational obstacles, which can include corruption, bureaucracy or environmental legislation. Political risk is not an exclusive quality of developing countries but they are more common than in developed countries. From these definitions it is possible to consider that when a political or economic event affects an organisation in a significant, negative way, it is classified as a risk. It is not wise to make generalisations in this field because a particular event may not affect all MNCs in the same way.

Political risk is different for each company since the characteristics of the company will determine how susceptible it is to political risk. Some political changes will adversely affect the company while others will probably improve the firm's conditions. The characteristics, such as the goals of the firms, internal structure, share of ownership, product and position within the country are essential in determining the political risk it faces. As the case studies will show, even if the six companies are operating in the same sector and are exposed to the same environment, the events do not affect them equally. What is clear is that many authors separate risk from uncertainty. [4] The risk exists and is a fact but uncertainty, which is really doubt, causes managers to make preparations that may avert that risk.

Some risks might be classified as economic and they are identified just by origin, a currency devaluation. Other risks have a political source, they relate to power or authority relationships and here political instability is identified with either violent events, riots or assassinations. This differentiation causes a problem; where to draw a line between political and economic risk: "Although government decisions are always political, by definition, the forces dictating the decision may be purely economic." [5] In other words, changes in the business environment might be a result of an economic policy that does not have any politically motivated reason but which affects the activity of the company. This differentiation deserves some discussion because it seems that some authors insist on a separation between politics and economics, when in fact they can not be divorced. As Gilpin stated some time ago, economics and politics are distinct but they depend on one another. [6] To reinforce this idea, Susan Strange said that separating what is political from what is economic is an illusion, which does not apply to the real world. [7] Based on these statements, it will be argued that, in fact, politics and economics are two different disciplines and that politics, of its own nature, is more uncertain than economics but they have a direct relationship. Therefore, we will define political risk as any political or economic event whose outcome negatively disrupts the activities of an MNC. It is our belief that instead of using the term 'political risk' it would be better to use the term 'political-economic risk', which embraces all the non-commercial risks that impact on the MNCs.

Among the factors of political-economic risk are social unrest and disorder; these are not directed against foreign companies but may affect business activities. The causes of social unrest may range from extreme economic hardship to racial disorders. [8] Another source of political-economic risk is a change in the law which may put ownership in danger or directly affect the conditions of FDI. Finally, one of the causes that ought not to be underestimated is the political influence of local business. Governments tend to support and protect their own businessmen but this position may change because of the economic and political requirements of the nation; if national businesses feel threatened by the presence of FDI they will certainly react. In a later chapter the influence local businessmen have had on the actions of the Mexican government, concerning the participation of FDI in the economy, will be considered.

Stefan Robock and Kobrin agree in identifying two types of risks, those that are 'macro', that act on all firms in more or less the same way and are unanticipated and politically motivated, such as the Cuban or Iranian revolutions, and those that are 'micro' which impact on a specific industry, company or project. The latter types of risks are more prevalent. The micro risks do not normally involve political conflict; they are changes in the policy of the host country government such as ownership regulations, restriction on remittances and exchange rate controls. [9] Changes in the exchange rate are a risk when using foreign currency and their effect is reflected in the balance sheet of the parent company. It is important for the MNCs to have a reliable economic environment in the host country. The businesses vulnerable to this type of risk will vary from nation to nation; dominance of a foreign company in an industry and the capacity of nationals to operate a business in that same industry are factors that change the vulnerability of such an industry. A characteristic of political-economic risk is specificity. The political environments can alter both the security of assets and the viability of operations; the latter is the most common. This classification also confirms that political-economic risk is not only a quality of developing countries, since all political environments change.

Even if revolutions, military governments, *coups* and other events affect the performance of MNCs, the most important source of political uncertainty is the policy of the host government which will reflect the interests and power of the different social groups in the country: the government, labour, local businessmen, military and consumer groups. This research will be dealing with 'micro' risks as defined above.

The Dimensions of the 1994 Crisis

The 1994 Mexican crisis was not limited to the devaluation of the peso in December; in fact, the devaluation was a symptom of the crisis. The socio-political events that took place in 1994 put pressure on the economy of the country and the result was the devaluation of the peso. The purpose of this section is to present the events of 1994 and the way in which they impacted negatively on the economy, eroding even more the already devalued Mexican peso.

On January 1st, 1994, the Ejército Zapatista de Liberación Nacional, EZLN, or Zapatista National Liberation Army, declared war on the government in the name of the people of Chiapas; they demanded the removal of the national president and the governor of the state, to be followed by free and fair elections. The rebels called for the support of all Mexicans. The causes of the uprising were poverty, racism and social inequalities; the government argued that its economic reforms were part of the solution in Chiapas, not part of the problem. The signing of NAFTA and the changes in the Constitution concerning land tenure certainly affected the rural and ethnic population. [10] Some of the southern producers, many of whom were located in Chiapas would not be able to compete with cheaper US imports. They did not have access to credit, machinery or to irrigation.

The Zapatistas did not pose any military threat but the government is under pressure to solve the socio-economic problems that gave rise to the EZLN. Chiapas is a rich state; it has land for farming, forests, is a major producer of coffee and an important supplier of the nation's electricity and oil. The problem is that the wealth is concentrated in few hands and most of the 'Chiapanecos' live in extreme poverty. The movement has raised concerns about human rights and has attracted the attention of the international community; it has become a blot on the reputation of the government. [11] This uprising showed how limited was Mexico's incorporation into the first world. The movement claims that ethnic groups are being exploited by an oligarchy and that in Chiapas, as in other states, there are no free, democratic elections.

If the Zapatista movement threatened the viability of NAFTA and the success of the economic policies of President Salinas, the political murders in the following months brought to light the malfunctioning of the political system. During the presidential campaign of 1994, the candidate of the PRI, Luis Donaldo Colosio, was assassinated, on the 23rd of March. Both the national and international financial community reacted with panic and the demand for Mexican securities fell. Colosio's death further tarnished the image of modern Mexico.

A few months later, on the 28th of September, a second political assassination took place; the secretary general of the PRI, José Francisco Ruiz Massieu, was killed. Both murders remained unsolved but it is believed that Carlos Salinas was involved. In an attempt to restore both the confidence of the Mexican people and also that of foreign investors, the government accepted foreign observers to scrutinise the general elections of August 1994. It is important to stress that in the past this would have been seen as an affront to national sovereignty. The government, and more specifically the PRI, realised that observers would guarantee that there would be no electoral malpractice and the result would be accepted. [12]

The 1994 elections were a step towards a true democracy. These elections were closely scrutinised and there were reports of some irregularities that raise suspicions about the tactics of the PRI. The real test for a political system is the peaceful transfer of power from one government to another, even a government of a different political party. It was difficult to believe that the PRI would reform to permit a biparty system; this reform was characterised as a 'mission impossible.' [13] The result of the 1994 elections was a signal that politics had changed. The opposition gained almost 50% of the votes, which meant that the PRI had to listen to the demands of the electorate and that a three party system, the PRI, the PRD and the PAN, was developing. Both the PAN and the PRD increased their share of the vote.

In the congressional elections of 1997, a real opposition emerged and the voters were presented with an alternative. Previous elections had been a formality and this had given rise to 'popular cynicism' but the elections of 1997 proved to be different. For the first time in 70 years, the citizens of Mexico City voted to elect their mayor; previously this position had been a presidential appointment. In the mayoral election, Cuauhtémoc Cárdenas and the PRD achieved 48.6% of the votes, the PRI 25.9% and the PAN 15.7%. [14]

Investors hoped that this new pluralism would bring further change in economic policy. However, the crisis within the PRI gave cause for concern, because they were in control of the senate and the presidency. It was possible that the PRI might have pushed an agenda which could paralyse policy making and the passing of legislation.

The devaluation was not an overnight event. The brief economic recovery, which started with the administration of President Salinas, in 1988, was already showing signs of faltering by 1991. The various pacts which Salinas had instituted to curb inflation were having damaging effects and, by 1993, the Mexican economy was stagnant. The cost of the fight against inflation was becoming very high. The productive structure of the country was being weakened, economic activity was slowing down and the commercial deficit and the deficit on the balance of payments were increasing. In 1993, top government officials were discussing whether they should continue to try to bring down inflation to international levels or to relax the exchange rate, in order to reduce the deficit in the current account. The Central Bank of Mexico argued that the huge deficit in the current account was caused by the fact that foreign investment was high and internal saving was low. In spite of this, the government decided to continue the fight against inflation which was reduced to 6% in 1994. The Zapatista movement added to the political and economic uncertainty which was fuelling internal inflation; by February 1994 the peso had lost 8% of its value. This meant that the peso had reached the bottom of the exchange rate band established by the government. This depreciation threatened to grow after the assassination of Luis Donaldo Colosio and the Central Bank of Mexico had to use its reserves to prevent a currency collapse. [15] Uncertainty was intensified by the assassination of the secretary general of the PRI, José Francisco Ruiz Massieu, in September.

The recovery seemed to be working at the macro level and by 1996, Mexico was second after Brazil in the Latin American list as a choice for foreign direct investors. It is worth mentioning that Mexico had kept the first position as a recipient country for FDI in Latin America since 1990. [16] Investors had been encouraged by the stability of the Mexican peso. The prospect of declining inflation raised hopes that Mexico might be about to embark on a virtuous circle of lower interest rates, healthier economic activity and stronger stock market prices. The improvement in economic conditions continued to attract investors. In an article in 'Director', December 1996, the author summarised those factors in the Mexican economy which made it attractive to FDI. The article mentioned conditions such as the size of the local population, the membership of NAFTA which opened the US market for Mexican goods, the possibility of selling to the rest of Latin America, the competitive labour rates and the relaxed investment regulations. [17]

British Multinationals investing in Mexico

Allied Domecq

Pedro Domecq is one of the oldest sherry companies in Jerez, Spain. The business started in 1730 and was acquired by the Domecq family in 1816. In 1941, the family extended its interests to Mexico and Pedro Domecq Mexico was set up as a subsidiary in 1956. Further subsidiaries were established in Latin America and Domecq developed as one of the largest drinks distributors in the region. Among the reasons for Allied-Lyons acquisition of Pedro Domecq was that they could build a strong portfolio in the principal spirits categories. The ownership would give Allied-Lyons better distribution of its products and facilitate the broadening of Allied-Lyon's businesses in developing markets. The acquisition would give Allied-Lyons six of the world's top 100 spirits brands. [18] At the time of the acquisition, in 1994, Allied-Lyons was the world leader in brands, it was second in sales volume and the fifth largest distiller in the world. The ownership of Pedro Domecq in Spain and Mexico brought the benefit of a better distribution of Allied-Lyons products and enhanced access to the Hispanic and the US markets, which are considered to have a high potential for growth. Allied-Lyons would now control 94% of its own spirits distribution worldwide. [19] In September, 1994 Allied-Lyons plc changed its name to Allied Domecq plc and its two core businesses started operating under the names of Allied Domecq Spirits and Wine and Allied Domecq Retailing. As a result of the acquisition of Domecq, the group reorganised its structure in 1995. The Pedro Domecq group holds an 83% share in Pedro Domecq Mexico which was the largest spirits marketer in Mexico, by volume, in 1992 and, in 1993, reached annual sales of 9.3 million cases.

Cadbury Schweppes

In January 1969 Schweppes and Cadbury merged. Technically Schweppes bought Cadbury but the new company bore the name Cadbury Schweppes. In March 1992 Cadbury Schweppes paid £188 million to Valores Industriales, Mexico's beer and soft drink giant, through its Femsa subsidiary, for the sale of its mineral water division, Aguas Minerales. Aguas Minerales is the leader in bottled water, both plain and fruit-flavoured; it includes Peñafiel, Balseca and Etiqueta Azul, which are estimated to have 68% of Mexico's mineral water market but only 6% of its soft drinks market. Mexico is the world's second largest market for carbonated soft drinks. The consumption per capita is on average 130 Lt a year, 50 Lt less than the US, and it grows 9% annually. [20] Peñafiel is the leader in the Mexican mineral water market. The investment in the manufacturing and launch of larger packages, both refillable and non-refillable, contributed to a strong sales performance, particularly in the second half of 1994, with a 12% increase in sales. Crush was included in Cadbury's acquisitions since it is distributed by Aguas Minerales in its operating regions and through Aga bottlers in new territories. In the sparkling water segment, Aguas Minerales dominated, with about 70% of the market in 1992. [21] After the acquisition by Cadbury Schweppes a new brand, Aguafiel, was launched.

This acquisition was among the largest by an overseas company of a Mexican business. The Mexican acquisition came about because Femsa was switching resources from soft drinks into banking, creating an opportunity for Cadbury. Femsa is the largest Mexican beverage and bottling company. About 18 months before the sale of Aguas Minerales, Femsa took on a large debt when acquiring a 56% stake in Bancomer, the second largest bank in Mexico, for US$2.88 billion. In 1993, after the deal with Cadbury, Femsa agreed to sell 30% of its soft drinks division to Coca-Cola for US$195 million. [22] Femsa was the owner of the Coca-Cola franchise in Mexico which accounts for 50% of Mexico's soft drinks sales.

Diageo

In 1926 Maxwell Joseph established his own property firm, Grand Metropolitan. In Mexico, Grand Metropolitan operates through franchises of Burger King and Häagen-Dazs; Green Giant is a maquiladora and it is seen as a subsidiary of Grand Metropolitan's US company, Pillsbury. The only direct investment was in José Cuervo. In

1964 Heublein began to import tequila from Cuervo to the US, and a decade later, to some European countries. After Heublein was acquired by IDV in 1988, a commercial link started and Cuervo was exporting tequila to IDV and IDV was exporting its products to Mexico through Cuervo. In 1991 Heublein Inc. acquired a 45% stake in José Cuervo. The agreement gave Heublein the exclusive right to import and market José Cuervo in the US; IDV was allowed to expand Cuervo's distribution worldwide. This deal strengthened the long-standing relationship among the companies. Tequila's exports started rising, from 28.5 million litres in 1983 to 47.3 million litres in 1993. [23]

During the 1960s Guinness through its spirits arm, United Distillers UD, was exporting its products to Mexico but, because of the need to have a better control of the market, they decided to establish a subsidiary. UD arrived in Mexico in 1992, through a wholly owned subsidiary. By 1994 it had a 41% market share of whisky, with an estimated sale of 880,000 cases annually. Its portfolio comprises fourteen well known brands, including Johnny Walker and Buchanans. It imports other spirits such as Hennessy cognac, Finlandia vodka, cherries Magno and Veterano, Campari, Gordon's and Tanqueray gins.

The merger of Guinness and Grand Metropolitan was announced on the 12th of May, 1997. In Mexico both companies, UD and José Cuervo, were still operating separately. Diageo only held a 45% stake in José Cuervo while it owned UD a 100%. José Cuervo's perception was that because UD was stronger in Asia and the Pacific and IDV in Latin America, their geographical scope was complementary. For Cuervo, the logical step was that UD became part of the Cuervo operation, because UD was smaller and the infrastructure and network of Cuervo were bigger. For UD Mexico, the merger with Cuervo seemed more complicated because Cuervo was an independent company and Cuervo and UD operated under different conditions.

Tate & Lyle

In 1870 Henry Tate built his own sugar refinery in Liverpool and formed Henry Tate & Sons. Abraham Lyle also started a refining business with his sons; in 1881, he bought Odam's and Plaistow Wharves on the Thames and built his own refinery. Tate was producing sugar cubes, while Lyle's specialisation was golden syrup. At the beginning of the First World War both were successful family businesses. In 1918 Earnest Tate approached Charles and Robert Lyle about the possibility of a merger. The two businesses complemented one another and they could share technical expertise. The negotiations dragged on until 1921 when Tate & Lyle came into existence. [24]

On the 16th of December, 1994, Tate & Lyle announced the acquisition of a 49% stake in Grupo Industrial Azucarero de Occidente in Mexico for £35.8 million. After the peso devaluation, it was necessary to make some adjustments to the original agreement but Tate & Lyle decided to continue with the transaction. The Sáenz family continued to own the majority share. Grupo Azucarero de Occidente had an estimated 7% of the Mexican sweetener market. The total market produces approximately 4 million tonnes of refined sugar a year. The top five sugar processors account for 60% of total Mexican output and 64% of refined sugar production, of which Occidente had under 15%. Occidente had two mills in the north-eastern state of Tamaulipas and one in Jalisco state. Tate & Lyle's investment had two immediate benefits. Firstly, it allowed Tate & Lyle to expand in an emerging market. Secondly, it would enable the group to take part in the expanding soft drinks market in Mexico. A growing demand was expected in the food processing and retail grocery markets. Occidente had a target production of 350,000 tonnes for the year 1998. [25] Tate & Lyle was only involved in the decision making process of Grupo de Occidente when there was need for investment. The Sáenz family controled the everyday running of the company. When Tate & Lyle invested in Grupo de Occidente it already had some investment in Mexico. During the 1970s, Staley invested in Mexico and it held 50% stake of Almidones Mexicanos, Almex, which was a corn plant producing HFCS -high fructose corn syrup. After the acquisition of Staley by Tate & Lyle there was major investment in Almex and the plant became bigger and more important. Tate & Lyle had 50% of Almex, plus their stake in Grupo de Occidente.

Unilever

Margarine Uni, a Dutch firm, came up with the idea of amalgamating with Lever Brothers and the merger was consolidated on the 2nd of September, 1929, under the name in English and Dutch respectively of Unilever Limited and Unilever NV. In Mexico, Unilever set up a soap joint venture during the 1950s but it was not until 1965 that the company was officially established with Zwanenberg, a meat processing business. [26] Throughout the years the acquisitions and movements of the group internationally have allowed the Mexican operation to inherit other businesses. In 1989 the various Unilever interests in Mexico ceased to function as separate entities and were organised into Unilever de Mexico. The various companies now became divisions of one company. This change gave Unilever more efficiency, stronger negotiation power with suppliers and customers and saved them time and resources. Unilever increased its interests in Mexico during the privatisation of the state owned companies. At the beginning of the 1990s, they acquired 'Industrias Conasupo' edible oil refiners and pasta makers. This acquisition gave Unilever better market coverage in central and southern Mexico. [27] The products of this company include crude refined vegetable oils, vegetable shortenings and pastas for soup. In 1990, Unilever bought seven Mexican companies from 'Valores Industriales', Clemente Jacques brands which are producers of tomato based sauces, chile products, marmalade, vinegar and processed foods, Mafer salted snacks, La Caperucita cheeses and animal feeds. [28] The Chairman of Unilever de Mexico stated that the move was going to boost its sales by over 25% in 1990 alone. Unilever also made acquisitions in the ice cream industry. Through a joint venture with Grupo Quan and Grupo Industrial Bimbo they already owned 51% of the shares in the ice cream market leader Helados Holanda. In 1998, Unilever acquired the rest of the shares. The deal included the local bakery brand, Carrancedo. [29] As a result of global restructuring, Unilever Mexico sold the chemicals division and also Zwanenberg the meat processing business at the beginning of 1997. In contrast they bought the margarine Mexican producer, Iberia.

The Impact of Political-Economic Risks on the Multinationals

In this final section an examination will be made of the information provided in the first four sections to discover if there is a common view expressed by all the parties questioned; if there are divergences in the material and what are the reasons for these divergences.

The parent company and the subsidiary are in a tight economic partnership and the success of this partnership is essential to the health of both parties. There is one vital difference; the Mexican subsidiary must succeed in Mexico; the multinational hopes to succeed in Mexico but a failure in Mexico, though it may damage the multinational, will not destroy it. This leads us to understand that greater sensitivity to Mexican conditions would characterise the local management, whilst the parent company focuses upon more global concerns. It is also clear that the MNC is able to exit a country and locate its resources somewhere else, but, as it will be explained, using Cadbury's case, once a multinational enters a country it is not that easy to exit.

The multinationals have a common view of the desirability of investment in Mexico; without exception, they see the geographical situation of Mexico as a great advantage in developing their business and using the country as a manufacturing base. This point of view was mostly expressed by the parent companies, which have a wider view and see Mexico as part of their worldwide strategy. The proximity of the large, developed North American market, which was reinforced by the signing of NAFTA and the possibility of using Mexico to extend their business in South America was agreed by all. As has been stated, this geographical position is undermined by the lack of proper communications with South America. However, since the geographical consideration was a major common denominator for all the MNCs, it must be assumed that they are aware of this difficulty and have plans to deal with it.

Equally the MNCs valued the size and structure of the Mexican market itself; a large, relatively youthful population promises a growing market as Mexico moves from the position of a developing nation to that of a developed nation. Because of their common hope for a better future, the parent company was prepared to accept some risk in the here and now. Although, for all MNCs, having a large market is beneficial, none seem to care about the disadvantages of this growing population. The most obvious is that unemployment might increase and the disparities between the rich and the poor will limit the domestic market and that affects negatively the sales and profits of any company. In fact it is the same MNCs that contribute to the increase in unemployment when they restructure their companies, as happened with Allied Domecq.

A second area of attraction was the high quality of Mexican management and the high level of skill of the Mexican workforce. Though this is a positive feature, it has a number of qualifications, which must be taken into account. These qualified personnel will be remunerated at a lower level than similar employees in developed countries, which reduces production costs, but the domestic purchasing power will be weak. All the companies are expecting a gradual improvement in the Mexican economy to produce a population which is better able to buy the goods produced by their subsidiaries.

The economic improvement referred to will have another effect; it will enable the Mexican government to invest more in the infrastructure and in particular in education. Though all agreed that the workforce was qualified, they said that the qualified group in the population was small and expanding companies had to compete for the small number of suitable applicants available.

Although all the parent companies agree on the advantages of the location of investment in Mexico, different companies were attracted by different features. Allied Domecq stressed that in a competitive world, it is necessary to be where your competitors are; Unilever sees an advantage in working in a country in which the bulk of the population is highly concentrated in three large cities, which could lead to economies of scale. Obviously for Cuervo and Domecq, who are involved in the sale of spirits, Mexico is the sole producer of tequila, the sale of which is growing worldwide.

This leads us to a consideration of NAFTA: all the companies examined stressed their hope that NAFTA would be a stabilising influence in both politics and the economy in Mexico. This was the general reaction, though NAFTA would affect different companies in different ways; Unilever would only benefit from the general stability, while Tate & Lyle would find NAFTA a positive safeguard to their future development. It is possible to say that NAFTA's effect on the subsidiaries will depend heavily on the nature of the structure of the MNC. The indirect benefit of this agreement is the certainty that this close alliance with the US will guarantee that there will be no going back on all the policies that had been put in place as part of the neoliberalist process. The particular benefit all MNCs would like to see is an improvement in the standard of living, which should be reflected in an expansion in their business.

NAFTA was clearly linked to another major event which took place in the period which we have examined, the peso devaluation of 1994. The rescue package negotiated by the US government prevented the Mexican economy from major disaster and started a slow revival. All the companies which we have examined were badly damaged by the peso devaluation and have had to adopt different strategies to cope. This raises an interesting question; to what extent had both the multinationals and the local subsidiary being affected by the general euphoria which prevailed in Mexico in the early part of 1994? Had any of the companies really expected the sudden collapse in the Mexican economy? In view of the fact that all took a period of time to organise their response, it seems obvious that the devaluation was unexpected. This would seem to contradict the assertion of the companies that they had plans and strategies to cope with any eventuality.

Some of the companies said that they have been long enough in Latin America to know how to cope with changes; however all of them were affected at least by a drop in sales, which would not be the case if they had been better prepared. This contradicts the view expressed by Cadbury and Unilever. All the companies were attracted to Mexico by the booming economy of the early 1990s. They thought that the economy would continue to improve and were certain that the political and economic changes promised stability. They failed to anticipate the collapse of the peso.

The peso devaluation, which was an economic event, was partially caused by events in the political field and was carried out by politicians. This was the greatest shock for the companies in the period studied and reminded them, very forcible, that they operate in a political economic nexus. No company wants to operate in an uncertain world and all have a strong wish for a stable economy in which to operate. Though all expressed their confidence in their ability to deal with whatever situation arose, we think their experience with the peso devaluation may call this competence into question. It is no surprise that companies stressed the stabilising possibilities of NAFTA.

The peso devaluation was an event with general and particular effects. All the MNCs suffered a drop in profits. The companies experienced different effects depending on the nature of their business and their reactions were framed accordingly. Allied Domecq was forced to bring its Mexican subsidiary more into line with multinational practice. Unilever, which, at a global level, was restructuring its business, speeded up the process in Mexico to come out of the crisis in a less harmful way. Tate & Lyle, paid less pesos for its share in Grupo Sáenz and did not consider the devaluation as a deterrent to carry on with this transaction. At the subsidiary level, the responses were more particular and examples were given about the different tactics adopted. At the end of the day, the subsidiary is the one that has to take the decision on how to react. All the multinationals stressed that they would basically support their local managers in their decisions.

The MNCs said that they were not interested in local politics; they had to deal with the political situation wherever they encountered it. Nevertheless, in the case of Mexico, as some of them mentioned, the collapse of 1994 arose from the political and economic situation of the country. It is contradictory for the MNCs to deny their interest in local politics when the local situation can so seriously affect their profitability. Their repeated assertions that they look for stability is in fact a statement that they look for stability in the political situation; they do have an interest in local politics. The various statements where they talked about having a good relationship with a certain political hierarchy or being able to ask the British Ambassador to lobby for them, demonstrates that they do care indeed about the politics of the country. This highlights the interest of the multinationals in the developing state of the Mexican political system. All believe that a multi-party democracy, which was evolving in Mexico, would provide a more stable economic situation. The parent companies interests were on the structural political transformation rather than being concerned with specific office-holders. Though none of the subsidiaries mentioned the next major hurdle, the presidential election in the year 2000, all the parent companies were very aware of this election; they would see the election of a non PRI president as positive proof that Mexico was becoming the developed country on which so much of their future prosperity will rest.

The view of the multinationals about the political future differed from the view of their Mexican subsidiaries. The subsidiaries are confident that the opening up of the economy to world trade meant that Mexico was much more a part of the world economy and this in itself promised stability. They thought that the reforms had gone too far for them to be reversed; Mexico was committed to a new way. For the subsidiaries, the multinational presence itself was a stabilising factor, while the parent companies saw the elections as a crucial moment in the political and economic evolution of the country. It was the test that would prove whether Mexico was continuing to evolve.

Once again there is a certain contradiction in the views expressed. All the MNCs originally invested in Mexico because the country was offering all the necessary elements for them to operate: clear regulations, improvement of the economy and political stability. It is only after the 1994 crisis that the multinationals seemed to re-consider this condition and even to assert that the coming into power of another party would be beneficial. Whatever the PRI has failed to do, one can not deny that it has provided stability to the country. Other Latin American countries have suffered military dictatorships and revolutions; this has not been the case in Mexico. In those other countries, the MNCs had to abandon their businesses because of the political and economic chaos. The PRI had certainly provided stability for a long period and it was in the past years that the politics of the country seemed to be entering a new era. Because of their long tenure of power, they were the only party with the experience of running the country. There was no guarantee that another party would improve the current state of the economy. If another party would come to power in the year 2000, Mexico, in the short and medium term, would enter a transitional period, which will have disadvantages. A price will be paid by both the Mexican population and the businesses operating in the country.

The fact was that the Mexican government was preparing itself for the 2000 elections. In the middle of June, the Mexican government asked its international lenders to make available at least US$11 billion. This was part of a package in which the IMF, the central banks of Canada and the US, the World Bank, the Inter American Development Bank and the US Export Import Bank will have ready for Mexico; this package amounted to US$23 billion. This was basically to avoid a financial disaster such as that of 1994. [30] Mexico's President at the time, Ernesto Zedillo, praised himself as being the only president who would quit office without causing financial turbulence.

All the MNCs were aware of the current problems of a developing economy such as Mexico; present instability, inflation and some uncertainty about the political and economic future. Though there was the hope that in ten or fifteen years time Mexico may have reached the stage of being a developed economy, this is not certain. There is always the possibility that any government will be tempted to take a short term, short sighted view of a problem, answer it in a way that will solve the problem for the present but will make the future more dangerous. Without exception the companies made reference to the future using words such as 'uncertainty', 'things could be better', 'risk', 'concern' and 'instability'. These terms imply a doubt about what the near future will bring and even if some of them seem to be prepared for another collapse, all want to be sure that in the long term political and economic stability will be guaranteed.

Those companies who have invested in Mexico are not looking for an immediate return, this is the US way, but they were looking for a steady development of the Mexican economy in a longer time frame. Even in developed nations, there is always the problem of the tension between the 'have's' and the 'have not's'. This problem is much greater in a developing nation, and the existence of a large, poorly paid, or even unemployed population is a spectre which looms over the future of Mexico; one company even said 'Mexico City is the time bomb ticking under the future of Mexico'. Inequality is both a political and economic challenge and one that must be overcome to secure the future of Mexico.

The solution to some of the problems that faced Mexico were postponed until after the election. The voters had expectations and the government did not wish to remind the population of the inequalities and poor conditions in which they had been living. The last presidential elections, 1994, made it evident that Mexicans had become more politically aware and this puts pressure on the government. The fear of anti-government demonstrations if PRI were to win in the year 2000 was very real.

It is interesting that, with the exception of Unilever, who clearly stated that they have strategies to cope with possible future variations in the political or economic situation, none of the MNCs commented on this. We would assume that all companies of this size also have similar strategic future planning. No company was prepared to reveal their future strategies but it is clear that the answer of the multinational may not always satisfy the local subsidiary. It is clear that, if the electoral watershed is successfully negotiated, the parent companies are confident about the long term prospects.

It is obvious that the relationship between the multinational company and its Mexican affiliate is controlled by the financial relationship between the two. Each of the six companies which we have examined is structured in a different way and follows a different strategy of investment. Unilever Mexico is a wholly owned subsidiary of Unilever plc; it was set up to sell and to manufacture the products of the plc in Mexico; in the thirty years in which they have traded in Mexico, Unilever has followed a strategy of buying local brands which fit in with their core lists of products. During the years that Unilever has been in Mexico, they have experienced different changes in the political economy of the country.

The parent company stresses that it is the task of the Mexican management to manage in Mexico but according to the strategy of the parent company. They wish to domesticate the Mexican company as far as this is possible, with a total Mexican management. Despite the fact that the internal structure of Unilever is confusing and has been criticised, is has proved effective, at least in the case of Mexico. A Mexican was appointed chief executive of Unilever Mexico. The control over the subsidiary is exercised directly from London, through the Latin American Business Group; this distance has not affected the performance of the subsidiary. Unilever Mexico has followed the multinational strategy of concentrating on its core business and has bought and sold Mexican companies in line with this strategy.

All the companies studied invested in Mexico after 1990 except Unilever which established its first company in the middle of the 1960s. Unilever's years of experience have made a difference and probably account for the almost perfect understanding between the parent and its subsidiary. In terms of the impact of and responses to the 1994 crisis, this company seems the least affected and best able to cope with the economic situation.

Domecq Mexico wants to use all the skills and techniques of their multinational parent to improve their situation in Mexico and to market their products in the world market. In this they have the full support of their parent company, who hoped to modernise without destroying the Mexican flavour. Domecq Mexico is in a transitional period, in which managerial modernisation is the name of the game. The modality adopted was that of interlocking managerial boards with cross-representation between the parent and the subsidiary. Since the acquisition, Domecq Mexico has been through a painful process of integration with the multinational. Both parent company and subsidiary know that there was a strong objection on the employees side in Mexico to changing the structure and way of operating the company. The British management was seen as a 'stranger', with a vision of improving profits but forgetting the fact that, in a family business, it is important to have the consensus and support of the employees to make change effective.

Tate & Lyle have long followed the policy of acquiring a share in the world market by buying a large minority stake in local sugar companies. Grupo Sáenz maintained a majority share in their company but relied on the support of Tate & Lyle to help them to modernise their business. This strategy had been successful and there was a fruitful relationship between the international company and its local partner. Part of this success might be to the cross-board representation, which gives the parent company significant control over major investment decisions. Tate & Lyle's target is not only growth through acquisitions but to transform themselves into a more efficient sugar producer. The case of this company is special and is the one which best expresses the sensitivity of agribusiness to politics. As they stated, sugar is a staple product and therefore consumption will not decrease but, at the same time, the government has to secure its supply and might restrict its import, set up tariff barriers and even control prices. This is clearly foreseen and understood by Tate & Lyle because they are already investing in all the forms of sweetness and would be ready to import and export from the US to Mexico and vice versa. This might help us to understand why at the time of peso devaluation they were prepared to continue with their investment. Economic liberalisation was a major factor in their decision to invest in Mexico; first, because of the privatisation of the sugar mills; second, because all the measures the Mexican government had taken were sufficient signs to Tate & Lyle of the clear intentions of the government to move towards a more liberal economy. Tate & Lyle's major concern is a change in government policy. This company diversifies the risks in two ways; it invests in all possible means of production of sweetness and it looks for a local partner.

The other two companies which we have examined, Diageo and Cadbury Schweppes, present a very different picture. Before the merger of Guinness and Grand Metropolitan, Grandmet had followed the same strategy as Tate & Lyle, buying a large minority holding in an old Mexican company, Cuervo. The reason that Diageo kept its Cuervo investment was the growing importance and consumption of tequila in the world market. It is time to analyse this fact, step by step. As Allied Domecq mentioned above, the drop in sales was reflected, during the 1994 crisis, by the changing pattern of consumer choice. This means that when a particular drink, in this case tequila, becomes fashionable it spreads easily and quickly in the global market. In the US, this consumption is partly affected by the large population of Latin Americans living there but there is no guarantee that this consumption will continue to rise or that the emergence of another spirit will not dim the popularity of tequila. The heavy reliance of both Allied Domecq and Cuervo on this spirit poses threats and risks that they do not seem to judge important, since they are directing large resources in developing this product. It is important to mention that from the 1st of July, 1999, tequila is an 'origin denomination' spirit and no-one in Europe will be able to use this name without the authorisation of the Mexican government. This is part of the negotiations that were taking place between the EU and Mexico towards a trade agreement. [31] This is good news for both Cuervo and Sauza, Domecq's tequila brand, since they together handle 80.5% of the total export market.

The future plans of Diageo will depend on the outcome of the legal battle with Cuervo. UD Mexico will continue to operate independently, as it has been doing but they were badly affected during the 1994 crisis, because all their product is imported and the price increased immediately. Diageo mentioned different actions taken to counterbalance the economic crisis but they did not give any hint of possible withdrawal, which is in itself good, because it means that regardless of the downturns, they are interested in keeping their subsidiary. Another reason could be that, if the negotiations with Cuervo did not turn out to be what Diageo hoped, UD could be handling the imported brands that used to be part of Grandmet.

The problems with Cadbury Schweppes and its wholly owned subsidiary were very different; Cadbury Schweppes, as a multinational, decided on a new world strategy; this involved the selling of their worldwide brands to Coca-Cola. This sale has been opposed by many governments, who fear that it would establish a monopoly for Coca-Cola in their national market; Mexico was one of the countries which had rejected the plan. This is a perfect example of the way in which even the most powerful multinational must take account of the policies of national governments, which Cadbury Schweppes has singularly failed to do: they may wish to carry out their international strategy but they will not be able to do it in the way that they had arranged.

It is surprising that both Cadbury Schweppes and Coca-Cola did not foresee the possible reactions of governments to their deal. The only explanation we can suggest is that Cadbury and more especially Coca-Cola thought that they were so powerful that they became confident in their ability to dominate any market and any government. It is clear that Cadbury did not consider all the possible scenarios when deciding to exit the Mexican market. They stated they knew Latin America well and yet their Mexican operation failed to produce the profits that they expected and they also failed to foresee the opposition of the Mexican government to their merger plans.

It has been shown that political-economic risks are not the same for all companies. The six MNCs examined were drawn to Mexico by the prospects of a strong, emerging economy at the beginning of the 1990s. Unfortunately the year 1994 illuminated the deficiencies of the country; Mexico had still a long way to go before it could be considered a 'safe and reliable' location for foreign investment. All companies were not affected in the same way; the dissimilar reaction may be explained by such factors as the ownership, the management structure and the nature of their products. A positive sign was the willingness of the MNCs to continue investing and their hope that the situation would improve. The British government was also optimistic and saw Mexico as an important investment recipient country. It was interesting to see how much was expected from the elections in the year 2000. For Mexicans, it represented an opportunity to put and end to a party dictatorship but for the MNCs it was an event that might brought better operating conditions for their businesses.

References

Contact the Author for a list of References.

End Notes

Contact the Author for a list of End Notes.

Assessing the Role of Risk in Growth and Development: Evidence from Latin American, African, and Asian Countries

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Abstract

Globalization through international trade and investment does not lead automatically to higher rates of economic growth. Models, which focus solely on traditional economic variables, often miss important institutional considerations that are essential to an effective transition to higher rates of economic growth. In turn, models that focus exclusively on institutional variables often exclude how institutional behavior affects the level of risk. In this paper, we examine traditional and institutional models of economic growth with and without explicit consideration of risk using a sample of 63 countries from Africa, Asia, and Central and Latin America for the 1980-2002 period. Using panel regression analysis, we find that risk is an important determinant of economic growth and that policy measures that take risk into account are an essential step to successful economic globalization.

Introduction

Does risk affect the rate of economic growth? The short answer is "yes" in that greater risk reduces economic growth through its impact on the costs of economic transactions. Since globalization can expose an economy to additional risk, how countries manage risk can have significant consequences on the rate of economic growth, particularly at a time when the role of international aid has become part of a renewed public policy debate[i]. Interestingly, much of the research on economic growth and political reform has proceeded with little direct consideration of how risk can arise and what institutional measures may be needed for its effective management in the efficient allocation of resources. In this paper, we use a sample of 63 countries in Africa, Asia, and Central and Latin America to examine how risk can explain differences in economic performance. Our findings help in understanding what measures may be needed for risk management within the context of continuing policy reforms.

Institutional Considerations in the Framework of Economic Growth

Growth theory can be distinguished between traditional and new formulations. While traditional theory has emphasized the growth of inputs and technological change through saving and trade, the new growth literature places emphasis on endogenous feedback effects. De la Croix and Michel [*2002*], and Aghion and Howitt [*1998*] provide useful syntheses of the new approaches to growth. In most of these formulations, little attention is given to the incorporation of institutional variables, a consideration that becomes particularly important when growth theory is applied to economic policy.

Incorporating institutional variables in the theory of growth owes much to Williamson [*2000, 1975*], Barro [*1998a, 1998b*], Temple [*1999*], and Easterly [*2001*]. Although focused initially on economic institutions, there also has been growing attention given to political institutions and governance [*Carlsson* and *Lundström, 2002; Saint-Paul, 2000; Persson* and *Tabellini, 2000; Ayal* and *Karras, 1998; Barro, 1996*]. While this literature provides a greater understanding of growth and development, we still confront significant gaps in policy implementation, as the recent critique of globalization by Stiglitz [*2002*] has shown. We consider some of these critiques in terms of economic and political institutions.

In his review of the new growth evidence, Temple [*1999*] notes the direct positive importance of international trade, investment in education and physical capital, technology adaptation and innovation, financial intermediation, and preventing excessive increases in income inequality as key factors in determining differential rates of economic growth. He finds that population growth rates and the presence of formal democracy are less important, even though these variables figure prominently in the formulation of domestic and international aid policies in many countries[ii].

Economic institutions favorable to economic growth can be subsumed under a grouping of economic freedom[iii]. Economic freedom, which includes property rights and judicial independence, can be constricted either by international aid, or by the lack of local participation and accountability in the political process. Jones, Hellman and Schankerman [*2000*] demonstrate that corruption and state capture arise more easily when accountability is low. In turn, De Soto [*2000*] emphasizes the importance of property rights by pointing out that weak regimes skew access to credit and thus limit the efficient allocation of resources.

In terms of political variables, increasing attention has been given to democracy as a determinant of economic growth, and to whether international aid plays a constructive role. Acemoglu [*2002*], Acemoglu, Johnson and Robinson [*2001*], and Barro [*1999*] find that democracy associates positively with economic growth, but much of the evidence turns on whether one is relying on what journalist Fareed Zakaria [*2003, 1997*] calls 'illiberal' as opposed to liberal democratic institutions. Some measures of democracy rely essentially on the frequency and transparency of electoral systems, and do not take into account the importance of an independent judiciary and property rights, nor of civil and political rights. Growth may falter, as resources are miss-allocated under nominally democratic but effectively corrupt regimes.

Much of the concern over illiberal democracy dates to Krueger's 1974 essay on rent-seeking behavior by political elites. Acemoglu and Verdier [*2000*] measure the tradeoff between market failure and corruption. In the presence of weak institutions where corruption and market failure is widespread, civil wars can ensue as well, as noted in Collier and Hoeffler [*1998*], Eldabawi and Sambanis [*2000*], Ellman and Wantchekon [*2000*], and Jenkins and Kposowa [*1990*].

As to international aid and its effect on growth, the evidence is mixed. In the post World War II Cold War era, international private capital flows were limited, and much development initiatives were driven by international public aid. Following the end of the Cold War, greater emphasis has been given to international private flows. A number of studies have pointed to weak links between the level of international public aid and rates of economic growth and development [*Easterly, Levine*, and *Roodman, 2003*; *Barro, 1998a*; *Casson, 1986*; *Collier* and *Dollar, 2002*; *Collier* and *Dehn, 2001*; *Deverajan, Rajkumar,* and *Swaroop, 1999*; *Guillamont* and *Chauvet, 2001*; *Hansen* and *Tarp, 2001*; *Hansen* and *Tarp, 2000*; *Knack , 2000*; *Lensing* and *White, 2001*; *Mosely, Hudson,* and *Horrell, 2001*]. While the performance of international aid is not our central concern here, the question is why it has been less effective than many of its proponents have claimed.

One finding is that international aid can undermine political accountability [*Knack* and *Keefer, 1995*]. In turn, low accountability can lead to political instability. Mbaku and Paul [*1989*], demonstrate how political instability creates additional opportunities for corruption and inefficiency. Easterly [*2001*] and Huther and Shah [*2000*] further examine the links between corruption and international aid and efforts to promote democratic reform. Consistent with other findings, they note that aid does not necessarily lead either to improved economic or better political governance.

In contrast, Burnside and Dollar [*2000*] find a positive impact of international aid on economic growth. In turn, given growing concern over international security, there has been a new willingness to re-craft increased levels of international aid, notably the U.S. commitment to the Millennium Challenge Account [*Radelet* and *Herring, 2003*][iv]. While much of the recent interest in international aid is its potential in establishing improved governance, in our view, greater attention to how governance affects the level of risk can be even more critical to its success.

How important, then, is democracy to economic growth and development? While there is a direct relationship between democracy and development, whether democratic political reforms should proceed economic reform is still subject to debate. Comeau [*2003*] and Boko [*2002*] find that democracy expands the level of per capita income, even though some qualification may be needed[v]. As Barro [*1998a*] notes, what is more important, is the emphasis on the corollary institutions of civil society such as civil and property rights, and an independent judicial system, which together can determine the success of democratic reform in achieving both economic freedom and economic growth[vi].

Linking Risk to Institutional Models of Economic Growth

If the evidence linking democracy to economic reform is mixed, one reason may be that insufficient attention has been given to the role of risk. Indeed, Temple [*1999*] notes in his conclusion, one of main reasons why growth rates differ is that macroeconomic stability differs across countries[vii]. This now is changing, particularly in light of the East Asian financial crisis of 1997. In their review of the effects of financial globalization on developing countries, Prasad, Rogoff, Wei, and Kose [*2003*] note that financial integration can increase macroeconomic volatility, whether measured in terms of rates of growth of GDP, exports, or consumption. Fosu [*2002*] finds that political instability affects exports even more than GDP growth. In turn, Athanasoulis and Wincoop [*1997*], and Wincoop [*1999, 1994*] find that sharing economic risk can reduce growth uncertainty, and that measures to do so can increase social welfare in terms of higher levels of per capita income and wealth. This approach builds on a framework first put forth by Obstfeld [*1994*].

There are two basic and complementary approaches to the incorporation of risk in globalization models. One is the construction of instability indices of an output variable such as GDP or exports and then to explain this in terms of standard variables such as the degree of trade openness and financial integration. In a perfect market, asset prices incorporate such risks. For example, a country's external borrowing rate should embody a risk premium, just as an internal lending rate should do. Yet in the presence of imperfect information, asset prices do not fully embody risk and a miss-allocation of resources may result.

Another approach is to define an index of aggregate risk that incorporates a weighted mix of economic and political factors. The World Bank routinely takes into account sovereign debt ratings by private firms in its assessment of lending decisions. It also is paying closer attention to country composite risk, which becomes useful as a broader tool that incorporates political and economic factors. Moreover, country composite risk indices also may be useful where sovereign debt markets do not exist or work in fairly imperfect markets. Because we are interested in the broader dimensions of risk in the context of globalization, we use a country composite risk index for our analysis.

As we have pointed out, risk raises the cost of economic transactions. Other things equal, increases in the level of risk lower a country's rate of economic growth. Since there are many forms of risk, it is useful to note the various forms in which it can arise, as we illustrate in Fig.1.

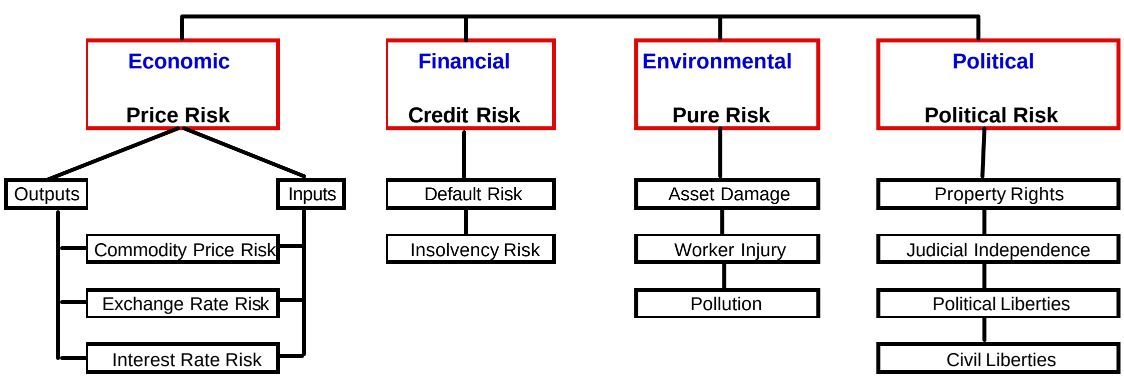

FIGURE 1
FUNCTIONAL CATEGORIES OF RISK

If there is a limitation to using a country composite risk index, it primarily does not separate the sources of risk into their respective sub-categories. Secondly, it may be considered as a "soft" variable in that it does not reflect directly observable behavior such as a coefficient of variation of GDP or export growth rates. Third, it generally relies on weights that are applied uniformly across countries in time and space when the evolution of determinants may vary. Despite these limitations, we find that a country composite index can be used to derive empirical support for the importance of risk management strategies in the context of globalization. We use the International Country Risk index for this purpose[viii].

Fig. 2 illustrates the basic relationship between country composite risk and real per capita GDP. Table A.3 in the Appendix lists the 63 countries used in the analysis, along with specification of the geographic panel groupings. For our present purposes, these geographic groupings do not rely on policy samples of reforming and non-reforming countries.

For our analysis, we are interested in the relationship of country composite risk not only to real per capita GDP, but also to standard determinants of economic growth, notably the national saving rate and the degree of trade dependence. Trade dependence captures some but not all of the dimensions of financial integration. For our purposes, trade dependence serves as a proxy for globalization of an economy.

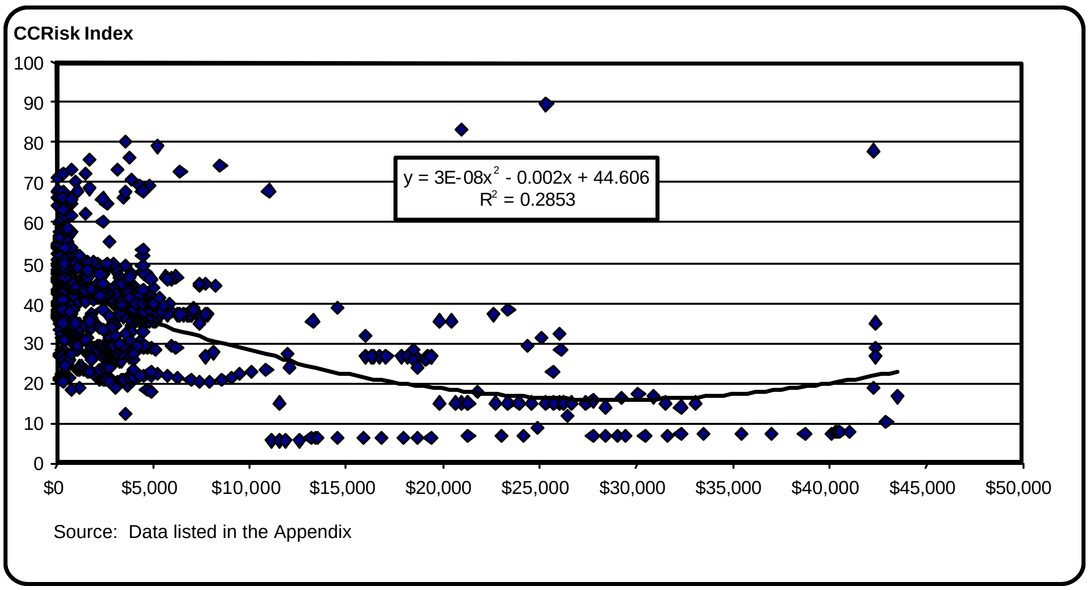

FIGURE 2
COUNTRY COMPOSITE RISK AND PER CAPITA GDP

Figures 3 and 4 summarize the basic relationship between country composite risk and the gross national saving rate and between country composite risk and the degree of trade dependence. While they reflect the global sample only, our econometric estimates provide panel separations by regions.

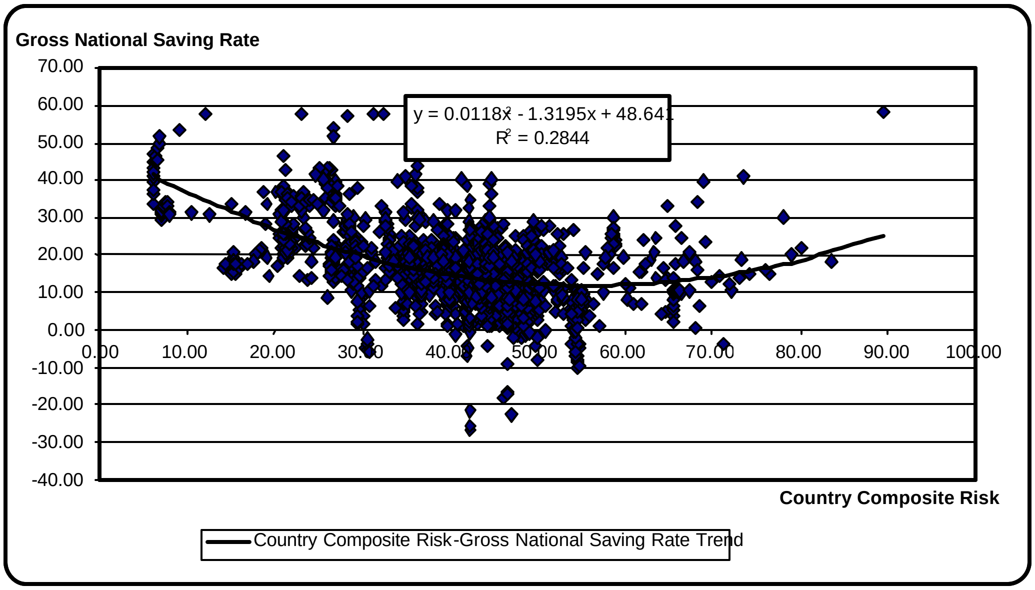

FIGURE 3
COUNTRY COMPOSITE RISK AND THE GROSS NATIONAL SAVING

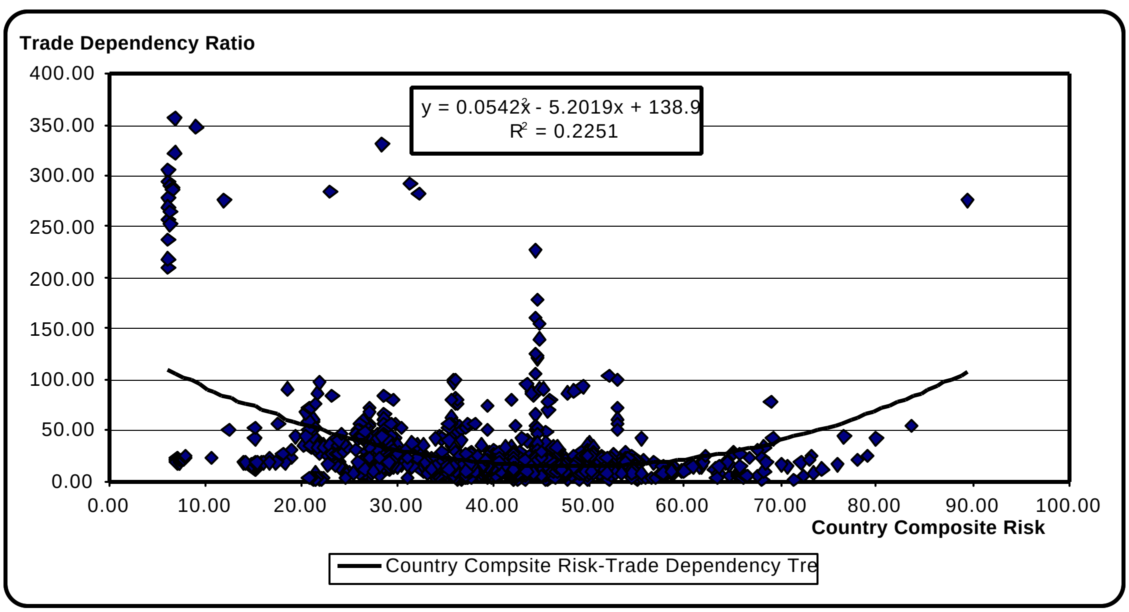

FIGURE 4
COUNTRY COMPOSITE RISK AND TRADE DEPENDECY

Given the inverse relationship posited in the pooled sample, we seek to examine the determinants of country composite risk, and how they determine in turn economic behavior across the respective regions; in our sample of East Asia, Sub-Saharan Africa, and Central and Latin American countries.

Modeling Risk in Economic Growth

We outline here three models of economic growth, beginning first with a traditional formulation of growth under globalization. In turn, we then modify this framework to include institutional variables. We then incorporate aggregate risk. In each stage, we derive random effects panel regression estimates, and report with respect to pairing Granger causality tests statistics from the pooled samples consistent with the sequential modeling framework illustrated in Fig. 5 below. In each case, the dependent variable on per capita real GDP, and all variables are expressed in log values.

In the absence of specific consideration of risk, a country's rate of economic growth depends in the first instance on a set of basic economic variables. These variables include the national saving rate, the level of trade dependency, the overall tax burden, the external debt service ratio, and interest rate differentials. Trade dependency serves as a proxy for globalization, while the savings rate, tax burden, debt service ratio, and interest rate differentials reflect a mix of domestic and international policy determinants of growth.

Other things equal, the saving rate relates positively to the growth of per capita income, as does the level of trade dependence. As to the tax burden, globalization implies in principle a reduced role by the public sector. However, the tax burden can relate positively to the growth rate of per capita income as long as public sector intervention is used to enhance the productive capacity of the economy. Thus, while we include the tax burden as a measure of public sector intervention, we leave open the question of whether it contributes positively or negatively to the growth rate of per capita income. We include an economy's external debt service ratio to capture the effects of public sector misallocation as well as imperfections in the mix of internal incentives on economic efficiency. Finally, we include interest rate differentials as an indication of the degree of local economic competition[ix].

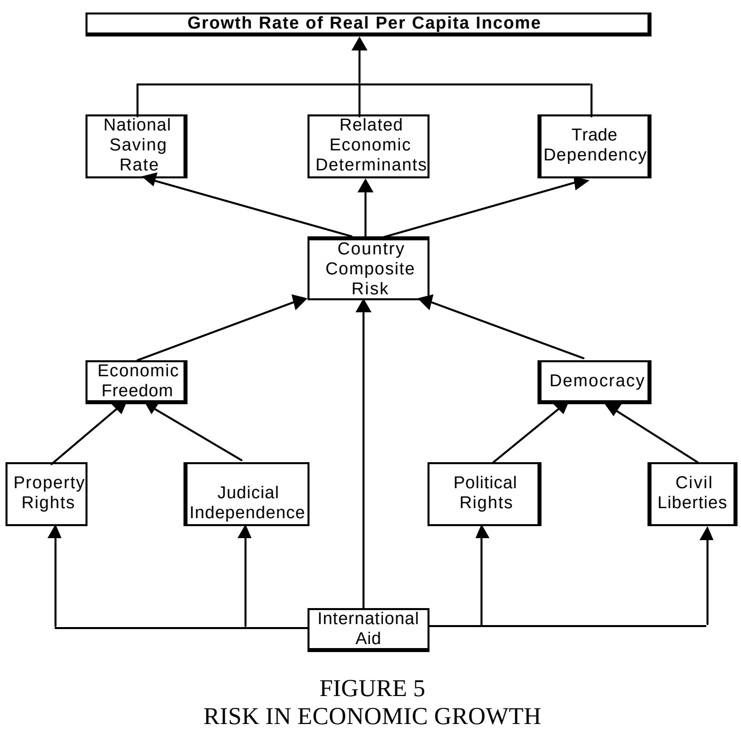

FIGURE 5
RISK IN ECONOMIC GROWTH

Based on our sample, we summarize estimates from the random effects panel regressions for all 63 countries, as well as for geographic sub-samples for the 1980-2002 period, in Table 1 below[x]. Below each regression coefficient is the corresponding computed t value, as well as the Granger null causality F tests for 2 period lags[xi]. All regression estimates are based on log values. The dependent variable is the log of real per capita GDP.

TABLE 1
BASIC ECONOMIC GLOBALIZATION MODEL

Random Effects Panel Regression Estimates

	Global	Africa	Asia	C&L America
Panel n	63	30	13	17
n	1224	437	246	325
Constant	1.8297	1.0716	0.8735	1.0034
LogGNSGDP	**0.2266**	**0.1310**	**0.0985**	**0.1176**
t	(9.029)	(4.431)	(2.143)	(2.849)
Gr	(11.661)	(7.006)	(1.312)	(3.718)
LogTRDEP	**0.6374**	**0.9065**	**0.8404**	**0.8478**
t	(22.292)	(17.982)	(18.763)	(20.638)
Gr	(1.643)	(1.995)	(0.424)	(1.410)
LogTAXBURD	**0.2051**	**0.3109**	**0.6727**	**0.4711**
t	(3.513)	(3.377)	(6.949)	(5.165)
Gr	(3.956)	(1.995)	(2.343)	(1.194)
logDEBTSRAT	**-0.1551**	**-0.1260**	**-0.2806**	**-0.2364**
t	(6.510)	(3.254)	(6.481)	(6.095)
Gr	(2.562)	(3.890)	(0.711)	(0.056)
LogIRSPRD	**-0.0392**	**0.0931**	**0.1646**	**0.1632**
t	(2.325)	(3.528)	(6.589)	(6.938)
Gr	(7.475)	(0.838)	(5.443)	(1.265)
Adjusted R^2	0.8836	0.8946	0.8955	0.8765
SEE	0.5340	0.4586	0.1467	0.1453

Standard policy prescriptions follow directly from this first model. They include measures to raise the national savings rate, measures to expand international trade in the economy, raising taxes while reducing government spending to reduce the debt-service ratio. They also include measures to lower interest rate differentials between the international and domestic economy (which implies for the respective regions, adjusting interest rates to stimulate investment spending)[xii]. Results for all regions are statistically significant and provide support for traditional approaches to policy reform, as countries move toward globalization.

While the standard model explains much of the variation in growth rates, it does not include major institutional variables. Moreover, while results are statistically significant, Granger causality test levels are not statistically significant in several cases. We note that for Africa, except for the savings rate and the debt-service ratio, other variables do not meet the Granger null at the 5 percent level or better. For Asia, Granger null tests fail for the savings rate, trade dependence and the debt-service ratio. For Central and Latin America, all variables satisfy the Granger null causality test, except by the saving rate.

Specification of Institutional Considerations in Estimates of Economic Growth

As a second approximation, we reformulate our model of economic growth to include institutional variables. In terms of institutional variables, the most frequently cited are economic freedom and democracy. The assumption here is, that economic growth will be greater not just in terms of a higher savings rate and greater trade dependence, but also the higher is the level of economic freedom and the level of democracy.

TABLE 2
ECONOMIC FREEDOM AND DEMOCRACY IN A SIMPLE GLOBALIZATION MODEL
Random Effects Panel Regression Estimates

	Global	Africa	Asia	C&L America
Panel n	63	30	13	17
n	1276	453	261	340
Constant	1.8589	1.3741	1.5839	1.5951
LogGNSGDP(-1)	**0.1879**	**0.1310**	**0.1607**	**0.1252**
t	(6.829)	(4.903)	(3.609)	(3.243)
Gr	(11.661)	(7.006)	(1.312)	(3.718)
LogTRDEP	**0.5902**	**0.8310**	**0.8809**	**0.7944**
t	(20.991)	(23.116)	(20.860)	(20.241)
Gr	(1.643)	(1.995)	(0.424)	(1.410)
logECFREE	**0.3385**	**0.6557**	**-0.4448**	**-0.1463**
t	(5.351)	(6.110)	(3.097)	(1.091)
Gr	(25.855)	(2.457)	(8.746)	(0.127)
logDEMOC	**0.1789**	**0.0555**	**-0.1076**	**0.0191**
t	(4.582)	(0.930)	(1.846)	(0.376)
Gr	(9.676)	(0.970)	(1.088)	(0.108)
Adjusted R^2	0.8615	0.9006	0.8774	0.8542
SEE	0.2101	0.1466	0.1631	0.1629

We can define economic freedom in terms of three components: property rights, judicial independence, and the lack of corruption. In turn, democracy consists of political rights and civil liberties. We thus drop the role of taxes, the debt service ratio, and interest rate spreads by substituting economic freedom and democracy as determinants. Regression results are shown below in Table 2. As in the first model, the dependent variable is the log of real per capita GDP.B

In this version, the savings rate and trade dependency are statistically significant for all regions, even though Granger causality tests are weak for trade dependency. As to the institutional variables, economic freedom reduces the rate of economic growth in Asia and in Central and Latin America, while democracy appears to reduce the rate of economic growth in Asia and is statistically insignificant in Africa. When the savings rate and trade dependency are dropped, economic freedom and democracy do expand the rate of economic growth, but democracy is not statistically significant for Africa, Asia, and Central and Latin America, as are Granger null causality test results.

The Role of International Aid

One of the major debates on globalization is the role of aid in promoting economic freedom, democracy, and growth as globalization proceeds. Since economic freedom and democracy often are the focus of international aid, we reformulate our institutional model to include their impact on the rate of economic growth. We do so in two steps. The first is to examine the significance of aid directly on the rate of economic growth, followed by the significance of aid on the savings rate and on the level of trade dependency. Results are summarized in Tables 3 and 4. The dependent variable is the log of real per capita GDP.

Results in Table 3 provide evidence that international aid reduces the rate of economic growth at statistically significant levels across all regions, even though economic freedom and democracy appear to contribute to a higher rate. The question is how and why does this result appear?

TABLE 3
ECONOMIC FREEDOM, DEMOCRACY, AID, AND ECONOMIC GROWTH
Random Effects Panel Regression Estimates

	Global	Africa	Asia	C&L America
Panel n	63	30	13	17
n	1335	506	286	374
Constant	2.7965	2.9350	2.9281	2.8305
logECFREE	**0.7799**	**0.5487**	**1.5570**	**1.5912**
t	(12.890)	(3.955)	(9.455)	(10.763)
Gr	(25.855)	(2.457)	(8.746)	(0.127)
logDEMOC	**0.1580**	**0.0401**	**0.2654**	**0.1777**
t	(4.597)	(0.542)	(3.161)	(2.613)
Gr	(9.676)	(0.970)	(1.088)	(0.108)
logAIDGNI	**-0.3410**	**-0.4361**	**-0.6706**	**-0.5883**
t	(27.494)	(12.918)	(11.182)	(11.333)
Gr	(6.489)	(3.731)	(1.681)	(4.117)
Adjusted R^2	0.8585	0.8058	0.6965	0.6953
SEE	0.1935	0.2027	0.2551	0.2332

We find that international aid reduces the rate of growth in real per capita GDP through its effects on the saving rate and on the level of trade dependency. We regress to international aid separately on each of these variables to test this hypothesis, results for which are reported in Table 4.

TABLE 4
THE IMPACT OF INTERNATIONAL AID ON SAVING AND TRADE DEPENDENCY
Random Effects Panel Regression Estimates

	Gross National Saving Rate				Trade Dependency Ratio			
	Global	Africa	Asia	C&L America	Global	Africa	Asia	C&L America
Panel n	63	30	13	17	63	30	13	17
n	1287	475	274	357	1335	506	286	374
Constant	1.1649	1.1571	1.1865	1.1492	1.2647	1.5557	1.5375	1.5176
logAIDGNI	**-0.1169**	**-0.1938**	**-0.1988**	**-0.1574**	**-0.1302**	**-0.3596**	**-0.3815**	**-0.3581**
t	(8.238)	(4.875)	(3.026)	(2.609)	(8.785)	(12.810)	(4.732)	(5.311)
Gr	(3.870)	(0.214)	(1.337)	(2.457)	(2.439)	(2.077)	(0.891)	(2.267)
Adjusted R^2	0.5436	0.5085	0.4091	0.3960	0.5585	0.7016	0.3927	0.4013
SEE	0.2269	0.2575	0.2766	0.2696	0.2334	0.1761	0.3458	0.3073

While Granger null causality tests do not provide conclusive evidence for the estimates in Table 4, international aid does not provide conclusive evidence of a positive effect on the rate of economic growth. This finding is consistent with the emphasis on privatization as part of globalization. It also is consistent with the notion that historically, international aid has been designed to accomplish a multiplicity of outcomes, of which the concern for economic growth has been balanced with concerns for international security, among other considerations.

If economic growth is but one of several objectives of international aid, what, then, of the role of international aid in promoting one of its pre-requisites, namely, economic freedom, or its role in promoting democracy, which is often cited as one of its major objectives. We reformulate our estimates to provide separate estimates of the impact of international aid alone on economic freedom, and separately on democracy. Results are reported in Table 5.

TABLE 5
THE IMPACT OF INTERNATIONAL AID
ON ECONOMIC FREEDOM AND DEMOCRACY

Random Effects Panel Regression Estimates

	Economic Freedom				Democracy			
	Global	**Africa**	**Asia**	**C&L America**	**Global**	**Africa**	**Asia**	**C&L America**
Panel n	63	30	13	17	63	30	13	17
n	1335	506	286	374	1335	506	286	374
Constant	0.2279	0.2452	0.1758	0.1889	0.5189	0.5485	0.3265	0.3565
logAIDGNI	**-0.0229**	**-0.0778**	**-0.0206**	**-0.0146**	**0.0078**	**-0.0534**	**0.0555**	**0.0373**
t	(3.927)	(7.371)	(0.940)	(0.787)	(0.764)	(2.753)	(1.276)	(0.920)
Gr	(4.613)	(3.265)	(0.964)	(0.496)	(9.198)	(3.882)	(0.520)	(3.444)
Adjusted R^2	0.6647	0.6933	0.5990	0.6105	0.5415	0.4890	0.4278	0.3837
SEE	0.0901	0.0667	0.0914	0.0821	0.1599	0.1272	0.1840	0.1832

The impact of international aid on economic freedom and democracy is mixed. While not statistically significant for Asia and Central and Latin America, international aid appears to reduce economic freedom in all regions. While international aid represents an aggregate of public capital from all sources including multilateral and bilateral programs, the negative impact of aid on economic freedom seems surprising. Given the time period under review, since the first ten years corresponded to the end of the Cold War era, it may be that aid was less focused on the pre-requisites for economic growth than it has since become.

The impact of aid on democracy is also somewhat surprising. It exerts a negative influence in Africa, even though there is a positive association for other regions. However, the results are statistically insignificant for the global sample, for Asia and for Central and Latin America. Taken together, we find the impact of international aid on economic growth, economic freedom, and democracy either negative or weakly positive. In our view, one reason for this finding may be that the impact of aid on risk has not been taken more explicitly into account.

Factoring Aggregate Risk into Economic Growth

We now reformulate our growth model using an index of country composite risk as a determinant, results for which are reported in Table 6. Holding constant the level of risk, the national saving rate and trade dependency exert a stronger influence on the rate of growth. Moreover, the higher is the level of risk; the lower is the rate of growth, given a region's saving rate and trade dependency level. We qualify these findings in noting, however, that country composite risk is not statistically significant in the Asia and Central and Latin America panels.

TABLE 6
ECONOMIC GROWTH AND GLOBALIZATION WITH RISK

Random Effects Panel Regression Estimates

	Global	**Africa**	**Asia**	**C&L America**
Panel n	63	30	13	17
n	1338	475	274	357
Constant	3.1370	2.5062	2.0408	1.8746
LogGNSGDP	**0.2193**	**0.1508**	**0.1128**	**0.1156**
t	(8.360)	(5.164)	(2.417)	(2.959)
Gr	(11.661)	(7.006)	(2.957)	(3.718)
LogTRDEP	**0.5331**	**0.8209**	**0.8802**	**0.7700**
t	(20.599)	(22.245)	(21.330)	(22.673)
Gr	(1.643)	(1.995)	(0.424)	(1.410)
LogCCRISK	**-0.6779**	**-0.6103**	**-0.2584**	**-0.1578**
t	(13.478)	(5.188)	(1.667)	(1.138)
Gr	(15.844)	(12.005)	(2.957)	(0.727)
Adjusted R^2	0.8712	0.8837	0.8654	0.8499
SEE	0.2023	0.1584	0.1712	0.1655

We further examine separately the impact of risk on the saving rate and on the level of trade dependency. Results are reported in Table 7. Here we find that risk exerts a negative impact on the savings rate in all regions and is statistically significant in all cases except Africa. In turn, risk exerts a consistently and statistically significant negative effect on the level of trade dependency in all regions, even though Granger null tests are not statistically significant for Africa.

TABLE 7
THE IMPACT OF RISK ON MAJOR GROWTH DETERMINANTS
Random Effects Panel Regression Estimates

	Gross National Saving Rate				Trade Dependency			
	Global	**Africa**	**Asia**	**C&L America**	**Global**	**Africa**	**Asia**	**C&L America**
Panel n	63	30	13	17	63	30	13	17
n	1338	475	274	357	1386	506	286	374
Constant	1.4283	1.3574	1.8905	2.0677	2.0733	2.2367	3.0737	2.8745
LogCCRISK	**-0.1914**	**-0.2237**	**-0.5388**	**-0.6510**	**-0.5374**	**-0.6056**	**-1.1478**	**-1.0297**
t	(3.355)	(1.206)	(2.204)	(2.998)	(9.943)	(4.225)	(3.866)	(4.212)
Gr	(6.347)	(3.717)	(0.192)	(1.193)	(2.414)	(1.258)	(2.182)	(2.033)
Adjusted R^2	0.5447	0.4910	0.3953	0.3946	0.5720	0.6104	0.3769	0.3844
SEE	0.2274	0.2620	0.2798	0.2699	0.2305	0.2012	0.3503	0.3116

We now revisit the role of international aid and ask whether international aid increases or reduces the level of risk. Results are reported in Table 8. While the Granger null cannot be ruled out for Central and Latin America, international aid increases country composite risk at statistically significant levels in all of the panel estimates.

TABLE 8
THE IMPACT OF INTERNATIONAL AID ON RISK
Random Effects Panel Regression Estimates

	Country Composite Risk			
	Global	**Africa**	**Asia**	**C&L America**
Panel n	63	30	13	17
n	1335	506	286	374
Constant	1.5794	1.5814	1.5750	1.5817
logAIDGNI	**0.0417**	**0.0561**	**0.0479**	**0.0481**
t	(6.829)	(5.932)	(3.019)	(3.387)
Gr	(5.444)	(4.257)	(10.623)	(0.145)
Adjusted R^2	0.5347	0.6426	0.5553	0.5332
SEE	0.0979	0.0604	0.0666	0.0634

One has to ask what are the purposes of international aid. We have noted the perverse effects on the national saving rate, on trade dependency, and risk in Tab. 4 and 6, as well as the weak effects on economic freedom and democracy in Tab. 5. We conclude that while international aid may have short-term beneficial impacts in such forms as humanitarian assistance, the net effect does not strengthen the rate of growth for countries that increase their participation in the global economy.

Determinants of Aggregate Risk

What determines the level of aggregate country risk? While there are many components, we focus on the components of economic freedom and democracy as determinants of its level, holding constant the level of international aid, results for which are reported in Tab. 9.

TABLE 9

ECONOMIC FREEDOM AND DEMOCRACY DETERMINANTS OF RISK

Random Effects Panel Regression Estimates

	Country Composite Risk			
	Global	**Africa**	**Asia**	**C&L America**
Panel n	63	30	13	17
n	1335	506	286	374
Constant	1.7976	1.7519	1.7151	1.7250
logAIDGNI	**0.0249**	**0.0443**	**0.0499**	**0.0470**
t	(4.150)	(4.907)	(3.224)	(3.438)
Gr	(5.444)	(4.257)	(10.623)	(0.145)
logPROPRT	**-0.2916**	**-0.2798**	**-0.1605**	**-0.1764**
t	(8.452)	(6.992)	(3.138)	(4.105)
Gr	(10.823)	(3.366)	(1.767)	(5.003)
logJUDIND	**-0.1344**	**-0.0681**	**-0.1232**	**-0.1140**
t	(5.197)	(2.189)	(2.819)	(3.065)
Gr	(12.841)	(4.631)	(4.890)	(3.236)
Adjusted R^2	0.5713	0.6711	0.5801	0.5672
SEE	0.0940	0.0579	0.0647	0.0616

	Country Composite Risk			
	Global	**Africa**	**Asia**	**C&L America**
Panel n	63	30	13	17
n	1335	506	286	374
Constant	1.5903	1.5873	1.5809	1.5878
logAIDGNI	**0.0416**	**0.0556**	**0.0492**	**0.0491**
t	(0.006)	(5.811)	(3.079)	(3.436)
Gr	(5.444)	(4.257)	(10.623)	(0.145)
logCIVLIBS	**0.0205**	**-0.0074**	**-0.0164**	**-0.0146**
t	(0.027)	(0.279)	(0.492)	(0.530)
Gr	(2.963)	(1.851)	(0.324)	(2.594)
logPOLRTS	**-0.0425**	**-0.0036**	**-0.0014**	**-0.0028**
t	(0.021)	(0.129)	(0.051)	(0.121)
Gr	(2.941)	(1.183)	(0.413)	(0.598)
Adjusted R^2	0.5353	0.6412	0.5521	0.5308
SEE	0.0978	0.0605	0.0669	0.0636

Holding constant the level of international aid, stronger property rights and judicial independence are important determinants that reduce the level of country composite risk. While the Granger null tests do not hold for aid in Central and Latin America, and while the Granger null is not satisfied for property rights in Asia, and for judicial independence in Central and Latin America, all results are statistically significant. This suggests that economic reform, whether sustained through international aid or through domestic measures alone, should place priority emphasis on strengthening property rights and judicial independence, which reduces the level of risk, and thus raises the growth rate of per capita income.

The results for the democracy determinants are much weaker. While the expansion of civil liberties reduces the level of risk in African, Asian, and Central and Latin American countries, the results are not statistically significant nor do they meet the Granger null causality test. As to political rights, while their expansion also reduces country composite risk, the results are not statistically significant, and only for the global sample does the result meet the Granger null test.

Should countries ignore political reform in pursuit of economic growth and development? Clearly the answer is no unless greater democracy reduces the rate of economic rate of growth by some significant level. On the other hand, it is clear that expanding economic freedom through strengthened property rights and judicial independence can lead to significant outcomes on the rate of economic growth.

Strengthening property rights and judicial independence represent important steps in the expansion of economic freedom, which in turn expand the rate of savings and the level of trade dependence[xiii]. These variables carry more important, positive impacts on the rate of growth than efforts to raise the saving rate and trade dependency alone. In terms of risk management tools, it is important not just to emphasize property rights and judicial independence. It also is important to strengthen financial integration. Yet for financial integration to succeed, it also is important to expand ways of managing risk. This can occur not just through deposit, life, and property insurance programs, but also through the extension of risk management products to other stages in the resource allocation process. Shiller (2003) points to an expanding range of contracts through which we can better manage risk. The question is how to translate these innovations into useful products that can be used in the global economy, particularly those developing economies who are engaged in reforms designed to increase their participation in international trade and investment.

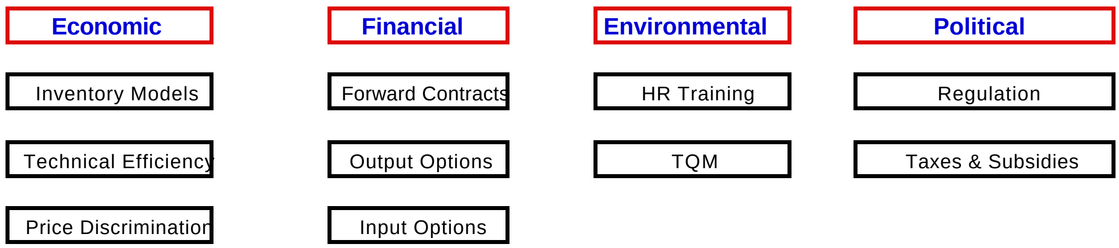

FIGURE 6
STRATEGIES FOR RISK MANAGEMENT

Figure 6 illustrates the range of areas for which risk management innovation strategies are appropriate. As globalization proceeds, for countries that depend on a focused range of exports, creating and sustaining markets for forward and futures contracts represents an important complement to the ongoing process of promoting foreign direct investment and the promotion of local equity markets.

Conclusion

As the literature on financial economics has shown, while risk cannot be eliminated, it can be minimized through diversification, through the creation of risk management contractual instruments, and through prudential management of economic policy. In turn, risk management also implies good governance of the political sphere, which is where concern over democratization comes into play. Democracy per se does not imply a higher or lower level of risk since countries may choose policies that are inconsistent with achieving sustainable rates of growth.

The challenge of globalization involves not just expanding international trade and investment. It also involves risk. Successful globalization will require a reformulation of economic policy to take into greater consideration the role of risk. Until now, most policies for globalization have been established either on purely economic determinants alone, or with some role for institutional reform. The next step is to factor risk more explicitly into the process of economic policy and institutional reform.

Appendix

Data Sources

Data used in this analysis have been compiled from several sources. We list below the variable and the source. All variables have been transformed into log values. The time period selected is 1980-2002.

TABLE A1
VARIABLES, INDEX SCALES, AND SOUREECES

Variable	Definition	Index Scales Low	Index Scales High	Source:
logRPCGDP	$U.S. 1995 real per capita GDP at official rates of exchange	*	*	WorldBank,World Development Indicators
logCCRISK	Country Composite Risk Index	1.00	100.00	ICRG, International Country RiskGroup,Syracuse, New York
logPOLRTS	Political Rights	1.00	7.00	Freedom House, the Heritage Foundation, and the Wall Street Journal
logCIVLIBS	Civil Liberties	1.00	7.00	Freedom House, the Heritage Foundation, and the Wall Street Journal
logDEMOC	Democracy Index	1.00	49.00	Product of political rights and civil liberties
logECFREE	Economic Freedom Index	1.00	5.00	Freedom House, the Heritage Foundation, and the Wall Street Journal
logTAXBURD	Tax Burden = Ratio of Taxes to GDP	0.99	33.89	World Bank, World Development Indicators
logAIDGNI	International Aid to Gross National Income ratio	-0.47	82.52	World Bank,World Development Indicators
logGNSGDP	Gross National Saving Rate	-26.55	58.20	World Bank, World Development Indicators
logTRDEP	Trade Dependency Ratio = share of GDP originating in international trade	1.94	354.80	WorldBank,World Development Indicators
logDEBTSRAT	Debt Service Ratio, as a percentage of Gross National Income	0.01	81.27	World Bank,World Development Indicators
logIRSPRD	Interest Rate Spread (LIBOR minus local Lending Rate)	-11.83	580.97	WorldBank,World Development Indicators
LogREALINRAT	Real Interest Rate	-98.15	789.80	WorldBank,World Development Indicators
logPROPRT	Property Rights Index	1.00	5.00	Freedom House, the Heritage Foundation, and the Wall Street Journal
logJUDIND	Judicial Independence index	1.00	10.00	ICRG, International Country RiskGroup,Syracuse, New York

TABLE A2
DESCRIPTIVE STATISTICS

	RPCGDP	CCRISK	POLRTS	CIVLIBS	DEMOC	ECFREE	TAXBURD
Mean	3070.993	40.254	3.959	3.830	3.926	1.810	14.917
Median	724.733	42.138	4.000	4.000	4.000	1.810	14.798
Maximum	43483.320	89.500	7.000	7.000	7.000	3.250	33.891
Minimum	84.723	6.000	1.000	1.000	1.000	0.100	0.990
Standard Deviation	6477.576	12.131	2.031	1.642	1.801	0.581	5.506
Skewness	3.840	-0.230	0.005	0.113	0.061	0.080	0.182
Kurtosis	18.690	3.950	1.620	2.198	1.815	2.778	2.610
Jarque-Bera	18423.190	67.208	115.064	41.927	85.627	4.520	17.232
Count	1449	1449	1449	1449	1449	1449	1449
	AIDGNI	GNSGDP	TRDEP	DEBTSRAT	IRSPRD	PROPRT	JUDIND
Mean	6.577	16.409	25.411	5.864	15.243	2.950	4.685
Median	3.066	15.605	15.898	4.841	8.461	3.000	4.583
Maximum	82.524	58.203	354.804	81.266	580.975	5.000	9.304
Minimum	-0.475	-26.550	1.940	0.008	-11.829	1.000	1.150
Standard Deviation	8.669	10.682	38.179	4.585	42.559	0.899	1.498
Skewness	2.627	0.492	5.482	4.472	7.637	0.596	0.433
Kurtosis	14.446	4.527	37.635	58.142	69.005	3.182	3.186
Jarque-Bera	9577.049	199.348	79683.550	188411.600	277118.000	87.735	47.352
Count	1449	1449	1449	1449	1449	1449	1449

TABLE A3
COUNTRY LISTING BY PANEL

Global	Africa	Asia	C&L America
Africa pane	Benin	Bangladesh	Belize
Africa pane	Botswana	China	Costa Rica
C&L America panel	Burkina Faso	India	ElSalvador
Canada	C.Af.Repub.	Indonesia	Guatemala
Mexico	Cameroon	Japan	Honduras
United States	Chad	Korea, Rep.	Nicaragua
	Congo D.R.	Malaysia	Panama
	Congo R.	Pakistan	Argentina
	Côte d'Ivoire	Philippines	Bolivia
	Ethiopia	Singapore	Brazil
	Gabon	Sri Lanka	Chile
	Ghana	Thailand	Columbia
	Guinea	Vietnam	Ecuador
	Kenya		Paraguay
	Madagascar		Peru
	Malawi		Uruguay
	Mali		Venezuela
	Mauritania		
	Mauritius		
	Mozambique		
	Niger		
	Nigeria		
	Senegal		
	South Africa		
	Sudan		
	Tanzania		
	Togo		
	Uganda		
	Zambia		
	Zimbabwe		
n = 63	n = 30	n = 13	n = 17

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End Notes

ii International aid, which has declined as globalization has proceeded, has recently been seen as an important instrument for undertaking sustainable political transitions, although its effects are subject to much debate. Much of this debate has arisen in the recent U.S. decision to launch the MillenniumChallenge Account aid initiative.

ii In the new institutional economics literature, the level of democracy is not easily measured. At one level is the tracking of elections in terms of participation rates, frequency, and other indications of popular participation. Ted Robert Gurr's Policy project has provided an important benchmark in the measurement of political regimes, and has a useful website with country-level estimates:

http://www.cidcm.umd.edu/inscr/polity/index.htm At the heart of the political economics literature is the debate on whether political democracy is exogenous or endogenous to growth. Much of the literature can be traced to Friedman's 1962 essay on *Capitalism and Freedom*, and which was expanded to international economic development with *Free to Choose* (1991). However, Friedman's point has been restated in terms of the distinction between whether economies have policies that support the necessary conditions for democracy and in turn whether those policies are conducive to economic growth

[iii] A more explicit definition requires specification of incomplete markets and the theory of contracts (Salanié, 2000).

[iv] Some of this interest may have been driven by security concerns following the events of September 11, 2001, but the agenda also seeks to encompass some of the governance issues in a more systematic way than has been done in the past.

[v] Comeau uses Raymond Gastil's Index of Political and Civil Liberties to derive a positive relationship between democratic institutions and economic growth for a sample of 82 countries in four continental regions. Boko uses the Freedom House survey of political and civil liberties (the successor to the Gastil survey) and the Polity98 indicators of democracy noted above to derive a positive relationship between democracy and economic growth for a sample of 20 countries in Africa. The measurement problem here is complicated by what Fareed Zakaria noted in his 1997 essay in *Foreign Affairs*, "The Rise of Illiberal Democracy." Zakaria pointed out that the policies designed to promote open and frequent elections misses the important corollary condition of the defense of civil and property rights, whose existence depends in turns on the existence and functioning of an independent judiciary operating under internationally recognized standards of law.

As to population growth, most studies confirm that strong efforts to restrict population growth work less well than efforts to promote education and economic growth, which in turn affect the choice of family size. Whether this justifies deliberate efforts to restrict access to information on family planning is, however, a different matter.

[vi] Barro (1998b) cites Milton Friedman's 1962 *Capitalism and Freedom* as a forerunner of many of the ideas that have guided the research on the new institutional economics of growth. However, he seeks to distinguish between the exogeneity and endogeneity of democracy. Barro cites Seymour Martin Lipset's 1959 observation by Aristotle that prosperity inspires democracy, meaning that democracy per se is endogenous to growth. This reinforces the notion in the previous reference that sustaining civil and property rights under an independent judiciary is an important precondition not just to growth but to the emergence of democracy in its fullest potential.

[vii] What makes this even more interesting is that the literature on financial economics is replete with measures and models of risk, yet there is little obvious effort to link this literature to traditional and new institutional models of economic growth.

[viii] International Country Risk Group index, World Bank, Washington, D.C. We have inverted the ICRG scale of 1-100 so that a higher number indicates higher levels of risk.

[ix] This measure is based on the difference between the LIBOR and the local mean central bank lending rate.

[x] Data sources and scales used are listed in the appendix.

[xi] Although Granger null causality tests may have a downward bias in a pooled sample, we report them nevertheless to provide some indication of the robustness of the reported t-statistics.

[xii] We have not specified other monetary variables such as the inflation and foreign exchange rate, but standard policies include emphasis on reducing the rate of inflation as well as adjusting the foreign exchange rate to internationally competitive levels.

The Risk Management of Taiwan's Venture Capitalists Invested in China: A Process Perspective

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Abstract

The transition from plan to market has become a dominant theme in China in the last two decades. A growing body of literature on the process of this transition has been produced. However, the issue of uncertainty and risk for foreign venture capital firms and other equity investors in the market has been neglected. The uncertainty and risks are emerging at a number of levels and areas. This article try to use a process perspective to identify the uncertainty the risks facing by Taiwan venture capitals operating in China and furthermore, offer some alternative solutions for every uncertainty or risk that we have found. Qualitative and open-ended responses to questions were collected from 13 VC principals, agent, and third-party. The content analysis method was adopted to examine the data collected. We offer some suggestions and solutions to manage these uncertainty and risks.

Introduction

Motivation

New businesses are subject to more market risk than established businesses because they are often exploring markets where competitive equilibriums among buyers, suppliers, potential entrants, current competitors, and product/service substitutes have not been established (Porter, 1980). Providing venture capital is a new financial services that has emerged in the sixties in the United States, came over to the United Kingdom in the seventies and developed in Continental Europe in the eights. The venture capital funds are managed by small teams of highly qualified venture managers, general partners of the fund, who will generally receive a part of the raised capital gains as an incentive. Its main objective is long-term capital gains to remunerate risks (Tyebjee & Bruno, 1984; Fassin, 1998).

Prior research has identified two types of risk relevant to venture capital investment: agency risk, which pertains to risk caused by divergent interests between venture capital firms and their portfolio firms, and market risk, which pertain to risk related to unforeseen competitive conditions affecting a market (Fiet, 1995). Clercq, Goulet, Kumpulatinen, and Makela (2001) propose that Fiet's concept of market risk covers two dimensions of risk, business risk and systematic risk. Business risk pertains to a lack of knowledge about the competitive conditions in a specific market, whereas systematic risk pertains to risk stemming from external factors not under the control of the venture capitalist (e.g. technological obsolescence). Both dimensions of market risk may have a detrimental effect on a given industry, company stage of growth, or geographic region. Based on these concepts of risk, Clercq, Goulet, Kumpulatinen, and Makela (2001) hypothesize that in an effort to achieve superior returns on portfolio company investments, venture capitalists will choose either a specialization strategy in order to control for agency risk and directly control for business risk, or a diversification strategy to control for systematic risk and indirectly control for business risk.

Purpose of Study

Because venture capital financing involves making decisions under conditions of high uncertainty, previous research has focused on the use of several criteria to determine whether or not to invest in a particular company: the venture's expected risk and return profile, the attractiveness of the product or market, the quality of the venture's top management, and the fit between the team's skills and the venture's apparent needs (Tyebjee & Bruno,1984; Goslin & Barge,1986; Hisrich & Jankowicz,1990). Rational decision-making models which follow a step-by-step and logical sequence have been used to describe the venture capital decision-making process (Tyebjee & Bruno, 1984). Frederiksen (1997) concluded that venture capitalists will not necessary engage in a logical step-by-step process when faced with decision characterized by a high degree of uncertainty. Further understanding of the venture capitalist's decision making process may arise when considering whether different factors become important during different stages of evaluation. For example, Zacharakis & Meyer (1995) found that the focus is initially on product and market characteristics, and later shifts more to the characteristics of the entrepreneur and the management team.

A review of the literature as above identified a number of factors that are deemed to be important in the evaluation of venture capital proposals. The most important of these were high risks, high expected returns, the lack of alternate traditional sources of capital and other non-financial factors such as the competence of management. Therefore, the purpose of this paper is, firstly, to briefly review those factors importance in venture capital risk management by process and secondly, to suggest some solutions for risk management when processing venture capital.

Literature Review

Risk of venture capital

Venture capitalists can be defined as any individuals or institution which provides "debt or equity capital for the growth of small business at any stage before going public" (Knight, 1973). Venture capital investing can be defined broadly as "investment by professional investors of long-term, risky equity finance where the primary reward is an eventual capital gain, rather than interest income or dividend yield" (Wright and Robbie, 1997; Parker & Parker, 1998). Fassin (1998) defined "Venture capital as a new financial service operates in the market of providers of funds and in addition in the market of service." Acker (1991) defined the venture capital industry has to position itself into a niche with other providers of capital. Therefore, this new service needs also a lot of general marketing communication: the promotion of venture capital as a specific product within the financial products or services.

Fiet (1995) compares risk avoidance strategies employed by business angels and venture capital firm investors. It finds that differences in their approaches to evaluating risk lead them to hold predictably different views of the dangers of market and agency risk. Market risk has been described in the strategy literature as the degree of uncertainty associated with gaining a competitive advantage due to environmental factors. The following potential indicators of market risk were thought to be among the most promising of those found in previous conceptual research: 1. Technical obsolescence can cause losses when entrepreneurs invest in specialized assets.2. Many competitors increase the difficulty of colluding to increase the level of joint profits.3. Many potential, new competitors increase the prospects that additional new firm will be bidding to provide more products/services at lower, more competitive prices.4.Many substitute product/ service blur any distinction is output held by supplier.5. Weak customer demand for a product or service cause sellers to offer concession that increase risk of market losses. 6. Market attractiveness is a function of its size, growth and accessibility and on the existence of a market need. The concept of agency risk has been described by financial economists, but only a couple of known studies have attempted to apply it in the venture capital arena (Barney, Busenitz, Fiet, Moesel, 1989; Fiet, 1991). The following potential indicators are extensions of those found in the mainstream literature and were selected for further study: 1.Potential dishonest entrepreneurs increase the risk that they will deliberately withhold information that is critical to equitable contract negotiation. 2. Entrepreneurs knowing more than venture capitalist about the enterprise constitute a form of information asymmetry that creates an agency risk when entrepreneurs are opportunistic. 3. Great distance to be traveled between the venture capitalists and the entrepreneur's enterprise increase the likelihood that less frequent monitoring will permit loss. 4. Short-term self interest seeking by the entrepreneur inhibits joint profit maximization for both the venture capitalists and the entrepreneur. 5. Numerous entrepreneurs to be monitored increase a venture capitalist's span of control and decrease the time that can be spent monitoring each venture.6. Not performing as agreed may result from either unforeseen circumstances or from self-interest seeking with guile.7 Game playing is a form of intentional self-interest seeking. There is a substantial evidence to indicate that venture capital firm investors view market risk as more threatening than agency risk. They may worry less about agency risk because they are able to protect themselves through the use of boilerplate contractual terms and conditions that they append to each venture capital agreement. Boilerplate reduces the cost of protecting themselves against agency risk by generating economies of scale in the writing of contracts (Fiet, 1995). Tybee & Bruno (1984) examined how venture capital firm investors evaluate the risk of a deal. They found that the venture capital firm investor's evaluation consisted of five assessment stage: market attractiveness, product differentiation, managerial capabilities, resistance to environmental threats, and anticipated cashout potential. Each of these stages evaluated market risk with the exception of managerial capabilities, which is an agency issue. In general, however, venture capital firms seem to be assessing market factors more than agency factors. Buhnka & Young (1987) concluded the loss percentage risk at different investment stages as follows:

TABLE 1 THE LOSS PERCENTAGE RISK AT DIFFERENT INVESTMENT STAGES

Investment stage	Risk of investment loss
Seed stage	66.2%
Start-up stage	53%
Second stage	33.7%
Third stage	20.1%
Exit stage	20.9%

Risk Management of Venture Capitalist

Reid, Terry & Smith (1997) has examined a sample of paired investor-invested relationships in the U.K. venture capital industry, with a view to analyzing how risk is managed, within a principal-agent framework. The involved analyzing risk management under four heading: expected return, portfolio analysis, screening, and risk sharing. The following conclusions emerge under each of these headings. 1.Expected returns: (1) Both investors and investees perceive themselves to be exposed to significant levels of risk; (2) Investees are inclined to considers their risk exposure to be irreducible; investors are more inclined to feel risk can be managed; (3) Investees take it for granted that risky situations involve an upside and a downside; investors are more inclined to seek means of enhancing the upside and attenuating the downside; 2.Portfolio balance: (1) Investors seek to construct a balanced portfolio, offsetting good outcomes against bad, by avoiding single sector and single technology investment involvements; (2) The average portfolio size falls short of that suggested by diversification considerations because of organizational feature; 3.Screening: (1) Risk/return analysis is widely used by investors; (2) Progression between perceived risk classes of investors is not proportioned . It may be subject to jumps; (3) At high level of risk, many projects are un-fundable, even to venture capitalists, as required IRRs are perceived as unbounded; (4) Investors assume investees will overstate returns and understate risks. They attempt to limit adverse selection by rigorous screening and carefully due diligence, leading to just 3% of proposal being backed; (5) Investees know investors screen with a fine filter and set high hurdle IRRs, and respond by over optimism in formulating their business plan. This partly sustains investor's expectations of adverse selection. 4.Risk sharing: (1) Invetsees overestimate potential rewards to investors, and investors overestimate risks of investees; (2) Investors seek risk-sharing benefits from their relationships with investors; (3) Both investors and investees dislike fixed pay-off arrangement for investees, feeling they disturb incentives on both sides; (4) Investees are sufficiently exposed to risk, post-contract, to sustain effort. Fassin (1998) provided a synthetic view on the venture capital process: Funds Raising, Deal Generation, Screening/ Analyzing, Investment, Monitoring, Exit. Once the team is formed, the primary task is funds raising. The complex and difficult exercise of funds raising from the team towards potential investors in venture capital funds: financial institution (bamks, insurance companies) and industrial institutions (big company). In order to select the possible investment

Methodology

Data Collection

The least structured form of interviewing is the non-structured or nondirective interview. Here no pre-specified set of questions is employed, nor are the questions asked in a specified order. Furthermore, no schedule is used. With little or no direction from the interviewer, respondents are encouraged to relate their experiences, to describe whatever events seem significant to them, to provide their own definitions of their situations, and to reveal their opinions and attitudes as they see fit. The interviewer has a great deal of freedom to probe various areas and to raise specific queries during the course of the interview. There are three interviewing method as above. The researcher asked interviewees to gather together for focused interview, but they refused to get together because of secrets. So, the researcher used the in depth interview and nondirective interview.

Sample design

We had in-depth interviews with 15 interviewees with either investment or market survey experience in China or having lived in China for some period of time. After obtaining their consent, we taped their reports for about 32 hours, which were later converted into written notes of 65 pages coded by serial numbers. We also requested background information of their companies and gathered press cuttings to complement the content of our interviews. When such initial decisions have been arrived at the researcher is ready to develop a list of interview questions or areas for observations. The initial questions or area for observation are based on concepts derived from literature or experience. Since these concepts, as you know, do not yet have proven theoretical relevance to the evolving theory, they must be considered provisional. Nevertheless, they provide a beginning focus, a place for the researcher to start (Strauss & Corbin, 1990). The content of our interviews consisted of the following aspects: 1. what risks you meet in every stages of venture capital? 2. How do you manage the risk in every stages of venture capital?

With respect to sampling, researchers must at first define the outline of the subjects in their studies to pinpoint their research groups. Then they determine their data profile (observations, in-depth interviews or literature analysis) based on the availability of the data and researchers' schedule. By taking the above sampling principle into account, we outlined our interviewees' profile based on purposive sampling method: 1.Members of Taiwan Venture Capital Association; 2.With experience in conducting business survey, participating in investment decision making and residing in China for several years; 3.Working at well-established firms (which would enable us to obtain valuable information for our analysis). Thanks to assistance from Taiwan Venture Capital Association and several VC firms, we conducted our interviews with the 13 persons working in the Taiwan VC industry. We interviewed the following 13 persons with impressive VC background; these are their sample profile as follows:

TABLE 2 THE RESEARCH SAMPLES

Code	Job Title	Sex	Age	tenure	education	Principal/agent
A	Chief Secretary	Female	45	16	Master	Third-party
B	President	male	52	25	Master	agent
C	Executive Vice President	male	46	15	Master	agent
D	Vice President	male	48	17	Master	agent
E	President	male	52	16	Master	Principal/agent
F	Executive Vice President, President of Business Unit	male	54	26	Master	agent
G	Vice President	female	46	14	Master	agent
H	President	male	48	16	Master	Principal/agent
I	Board Director, President	female	52	22	Master	principal

J	Vice President	male	40	12	Master	agent
K	chairwoman	female	62	30	Doctor	principal
L	President	male	45	15	Master	agent
M	Vice President	male	48	22	Master	agent

Data analyzing- Content analysis

Content analysis allows the investigator to observe a communicator's public messages at times and places of the investigator's own choosing. The procedure also allows him to carry out his observation without fear that the attention will bias the communicator, something that would be more difficult if the analyst were trying to watch at the scene (Budd, Thorp & Donohew, 1967). Berelson defined content analysis as a research technique for the " objective, systematic, and quantitative description of the manifest content of communication (Berelson,1952)? Holsti (1969) defined content analysis is any technique for making inference by objectively and systematically identifying specified characteristic of messages. No content analysis is better than its categories, for a system or set of categories is, in essence, a conceptual scheme. The analyst looks for classification categories in the nature of the research problem itself (Budd, Thorp, Donohew, 1969).We conclude six stages by above mentioned :1 Fund Raising**:** teams towards potential investors in venture capital funds: financial institutions, industrial organizations; 2. Deal generation: teams has to attract proposals from potential entrepreneurs; 3. Screening/ Analyzing : searching and accessing a great number of proposals and to the best deals ; 4.investment : venture capital fund managers select portfolio composition carefully. 5. Monitoring: venture capital funds do provide an active help and advice to their investee companies. 6. Exit: venture capital fund managers have to be very active is when they want to sell the company, either to a private investor or through an initial public offering (IPO) on the stock market (Fassin, 1998). We give definitions of every category and some example then began to code.

The smallest segment of content counted and scored in content analysis in the coding unit. The most common coding units are words, a theme or assertion, a paragraph, an item, a character, group, object, or institution, and space or time. While counting specific words is one of the easier forms of content analysis, it does not provide the analyst with as much information as some other methods. This study is used theme as unit of measurement. According to categories as mention above, we have 360 themes. Random sampling 90 themes from 360 themes to be pretest by researcher, two interviewees.

Reliability & Validity

A composite reliability coefficient may be computed by the following formula in which N denotes the number of judges. I choose two judges to count the pretest reliability. According to interview records, the number of sentences is 90. I count the reliability as follows:

TABLE 3 THE PRETEST RELIABILITY OF THIS STUDY

	Researcher	Judge 1
Judge 1	0.82	---
Judge 2	0.84	0.85

According to the formula, the average inter-judge agreement is 0.84, and the composite reliability score is 3(0.84)/1+2*0.84=0.94.The reliability is appropriate. I continue to the whole reliability. A composite reliability coefficient may be computed by the following formula, in which N denotes the number of judges. I choose all samples and two judges to count the reliability. According to interview records, the number of sentences is 360. I count the reliability as follows:

TABLE 4 THE RELIABILITY OF THIS STUDY

	Researcher	Judge 1
Judge 1	0.80	---
Judge 2	0.82	0.81

According to the formula, the average inter-judge agreement is 0.81, and the composite reliability score is 3(0.81)/1+2*0.81=0.927.The reliability is appropriate. Next, we concerned about the validity of this study. It also sometimes referred to as content validity, has most frequently been relied upon by content analysis. If the purpose of the research is a purely descriptive one, content validity is normally sufficient. Content validity is usually established through the informed judgment of the investigator. My research interviewed some experts in Taiwan who were experience, so this should be enough.

Result

Risks in the process of venture capital

This purpose of this paper is, firstly, to briefly review those factors importance in venture capital risk management by process and secondly, to suggest some solutions for risk management when processing venture capital. According to Fassin (1998), there are six stages of venture capital process as follow; we gave some scores by interviewees' responses:

TABLE 5 RISKS IN THE PROCESS OF VENTURE CAPITAL

	Funds Raising	Deal Generation	Screening/ Analyzing	Investment	Monitoring	Exit
A	3	3	3	3	4	5
B	3	3	3	4	5	5
C	3	3	4	3	5	5
D	3	3	3	4	4	4
E	4	3	4	3	4	5
F	3	3	4	3	4	5
G	3	3	3	4	5	5
H	3	3	4	4	4	5
I	4	3	3	4	5	5
J	3	3	4	4	4	4
K	4	3	4	4	5	5
L	3	4	4	4	5	5
M	3	3	4	4	5	4
	Funds Raising	Deal Generation	Screening/ Analyzing	Investment	Monitoring	Exit
Scores	42	40	47	48	59	62
Sequence	5	6	4	3	2	1

1: not very important 2::not important 3::important 4:middle important 5:very important

The result shows, sequence of importance of risks is exit, monitoring, investment, screening/analyzing, funds raising, and deal generation. The sequence is different form Buhnka & Young (1987). Their research emphasis risk on former stages but our research is on latter stages. Based on Regina, Chen, Liu (2003) suggested most Taiwanese VC firms prefer to build an overseas holding company to invest in China in a bid to hedge risks caused by inadequate exit mechanism and tightly foreign exchange control. Even if they are not allowed to transfer any of their original investment money, they still can have a full control of their capital inside China.

Risk Management in the process of venture capital

We concluded the 13 interviewees whose experiences of risk management in the process of venture capital in China.

TABLE 6 RISK MANAGEMENT IN THE PROCESS OF VENTURE CAPITAL IN CHINA

	Risk	Risk management
Funds Raising	Percentage of joint venture Government regulatory Exchange Ownership	Clear funding goal Exchange into RMB Trust
Deal Generation	Honest cooperation Conflict in concept Conflict in language Conflict in culture Personal moral Personal capability	Guanxi set up Careful recruit and select Investigate for family
Screening / Analyzing	No standard format of statement Dishonest in financial statement Cheat in financial statement	Trust set up Account audit Internal audit
Investment	Industry choice Company choice Selection portfolio composition	Make money industry Industry trend
Monitoring	Problem in Operation Dishonest in financial statement Cheat in financial statement	Branch set up Spend time for supervisor Communication Account audit
Exit	Price of target Percentage of equity shares IPO	Negotiation MBO Sell out

According to the result, in the fund raising stage, the risk management policy emphasis on clear funding goal, trusts build. In the deal generation stage, the risk management strategy focused on guanxi set up, carefully recruit and select good partners. Using account audit and internal audit to help evaluate related proposals plays an important role in screening/ analyzing stage. Choosing the making money industry is essential for investment stage. In order to prevent cheating, spend time for supervisor and account audit is necessary. At last, negotiation, management buy-out is good methods for risk management in the process of venture capital. This study used qualitative approach method to make conclusion on risk management methods of venture capital in China.

Conclusion & Suggestions

Conclusion

In order to boost operating efficiency and continue to expand business in an increasingly competitive global market, enterprises must go global. To achieve this goal, enterprises must adopt a successful entry mode. Taiwan Venture Capital industry has played a critical role in the rapid development of Taiwan's IT industries. To get a better understanding of how the VC industry in Taiwan has succeeded in this respect, we have conducted a research and interviewed 13VC professionals were interviewed with respect to their progress in moving into Mainland China. Then we have sorted and analyzed the information and data thus collected with advanced methods. In the end, we have come to the following conclusions: 1. the sequence of importance of risks is exit, monitoring, investment, screening/analyzing, funds raising, and deal generation; 2. we suggest some solutions for risk management of venture capitals invested in China.

Suggestions

Based on our research results, we would like to suggest the government, the VC industry and academic community take the following actions: firstly, thanks to the tax incentive plan initiated by the government, Taiwan VC industry was able to enjoy significant growth in terms of fund size and number of registered VC firms over the past decade. Now with the tax incentive gone, source of VC capital is expected to decline as institutional and individual investors have no incentive to invest in VC funds. As such, Taiwan's VC community is concerned about their future and has started to look elsewhere for investment opportunities. Therefore, we suggest that the government put further stimulating measures into place, speed up bank reform and open up financial market, so that new capital infusion can be directed into VC funds and Taiwan VC firms can continue to keep their roots in Taiwan. Secondly, this paper provides an empirical analysis of risk management arrangement adopted in the relationship between the venture capital investor and his investees by process perspective, it also give some solutions for businesses that are interesting to invest in Mainland China from all over the world.

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Contact the author for a list of references.

Strategic Control as a Critical Part of Strategic Management

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Abstract

Strategic control is presenting an integral part of strategic management and critical part of strategic management process. Under conditions of an uncertain and dynamic environment, managers often seek strategic control as an important way for enhancing and developing strategic management of their organization. There are many differences between operational and strategic control. In the theory of strategic management there are four basic types of strategic control: premise control, strategic surveillance, implementation control and special alert control. Each of this four types strategic control are important for successful strategic management of organization.

Strategic Management under Conditions of an Uncertain and Dynamic Environment

Competitive advantage is considered the basis for superior company performance. To perform at such a level consistently, a firm often has to pay attention to the evolving system of competitive advantages. Managers now face the task of creating and developing system of strategic management as a process that allows continuous management change and adaptation to a dynamic environment. Managers must recognize and cope with multiple states of coexisting stability and instability and be flexible in making rapid and effective changes.

Under conditions of an uncertain and dynamic environment, managers often seek to enhance their firm by developing control in management, specially strategic control in strategic management.

Strategic control consists of determining the extent to which organization's strategies are successful in attaining its goals and objectives. If the goals and objectives are not being reached as planned, then the intent of control is to modify the organization's strategies and implementation so that the organization's ability to accomplish its goals will be improved.

Operational and Strategic Control

Before we proceed to scan the term Strategic Control, we need to start with explaining what "control" is. Control, in the business administration sense, is most often discussed in the context of operational management or budgeting. In the control of operating and budgeting expenditures, the focus is usually for a time span of a year or less. Quantitative measurements are used to determine whether actual expenditures are exceeding planned spending, the emphasis is on internal operations. Corrective action is often taken after the budget period has elapsed.

But in strategic control, the focal time period usually ranges anywhere from few years over a decade, qualitative and quantitative measurement are taken, management assesses both internal operations and the external environment. The process is ongoing, because top management cannot wait for several years to evaluate results.

TABLE 1. DIFFERENCES BETWEEN OPERATIONAL AND STRATEGIC CONTROL

Operational control	*Strategic control*
Time period is usually one year or less	Time period is lengthy – ranging for a few years
Measurements are quantitative	Measurements are qualitative and quantitative
Concentration is internal	Concentration is internal and external
Corrective actions may be taken planning period have elapsed	Corrective actions are ongoing

Operational control systems require systematic evaluation of performance against predetermined standards or targets. A critical concern here identification and evaluation of performance deviations, with careful attention paid to determining the underlying reasons for and strategic implications of observed deviations before management reacts. Some firms use trigger points and contingency plans in this process. [3]

Strategic controls are intended to steer the company toward its long-term strategic goals. Strategic controls to meet top managements' needs to track the strategy as it is being implemented, to detect underlying problems, and to make necessary adjustments. These strategic controls are linked to the assumptions and the key operating requirements necessary for successful strategy implementations. Ever-present forces of change fuel the need for a focus of strategic control.

The "quality imperative" of the last 20 years has redefined global competitiveness to include reshaping the way many businesses approach strategic and operational control. What has emerged is a commitment to continuous improvement in which personnel across all levels in an organization define customer value, identify ways every process within the business influences customer value, and seek continuously to enhance the quality, efficiency, and responsiveness with which the processes, products, and services are created and supplied. This includes attending to internal as well as external environment.

Strategic control is a crucial part of strategic management process. Strategic management process consists from four basic parts (Fig. 1):

1. Environment scanning
2. Strategy formulation
3. Strategy implementation
4. Strategy control

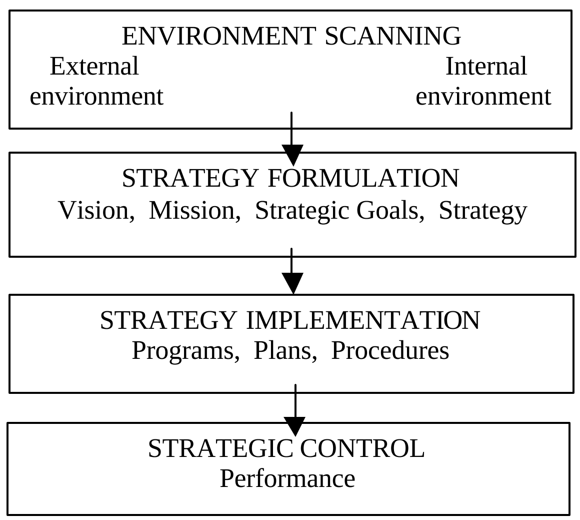


FIG. 1. FOUR BASIC PARTS OF STRATEGIC MANAGEMENT PROCESS [2]

Establishing Strategic Control

According to John A. Pearce II. [4] The control of strategy can be characterized as a form of "steering control". Ordinarily, a good deal of time elapses between the initial implementation of a strategy and achievements of its intended results. During that time, investments are made and numerous, projects and actions are undertaken to implement strategy. Also during that time, changes are taking place in both the environmental situation and the company's internal situation. Strategic controls are necessary to steer the firm through these events. They must provide the basis for adapting the firm's actions and directions in implementing its strategy to these developments and changes.

The four basic types of strategic control are (Fig. 2):

- ??Premise control – is assumption testing
- ??Strategic surveillance - is the open-minded monitoring of the internal and external environments to see if any assumptions you made about your strengths, weaknesses, opportunities, and threats have been violated.

?? Implementation control - depends upon your willingness to admit that your assumptions may be inaccurate when subjected to the day-to-day meat grinder test.

?? Special alert control - is simply a system designed to monitor your key assumptions that are critical to the success of your strategic plan, which assumes that you have identified those key assumptions.

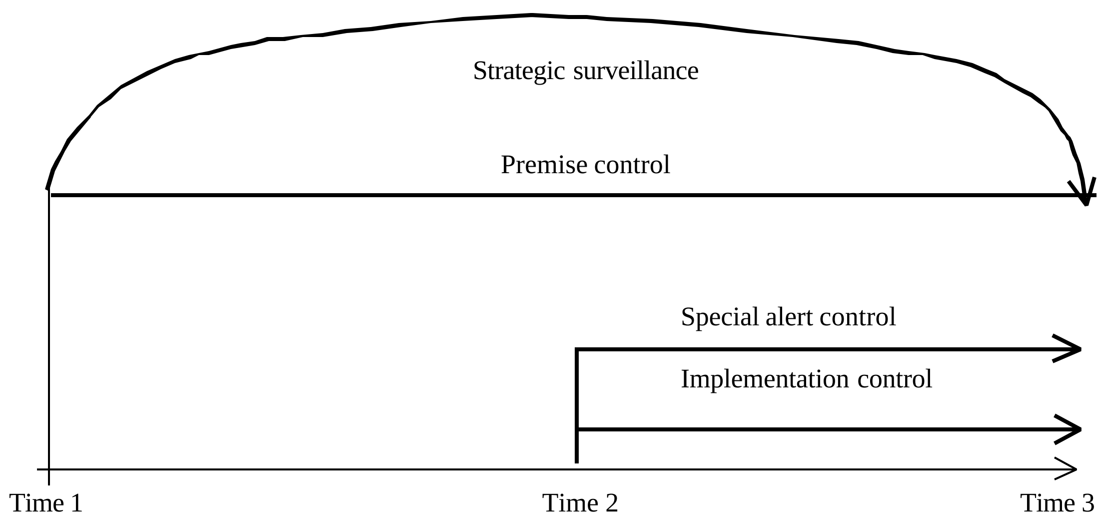


FIG. 2. FOUR BASIC TYPES OF STRATEGIC CONTROLS [4]

a) Premise control

Every strategy is based on certain planning premises – assumption or predictions. Premise control is designed to check systematically and continuously whether the premises on which the strategy is based are still valid. If a vital premise is no longer valid, the strategy may have to be changed. The sooner an invalid premise can be recognized and rejected, the better are the chances that an acceptable shift in the strategy can be devised.

Strategies are often based on numerous premises, some major and some minor, about environmental and industry variables. Tracking all of these premises unnecessarily expensive and time consuming. Therefore, managers must select for tracking premises whose change is likely and would have a major impact on the firm and its strategy.

b) Implementation control

Strategy implementation takes place as series of steps, programs, investments, and moves that cover over an extended period of time. Special programs are undertaken. Functional areas initiate strategy – related activities. Key people are added or reassigned. Recourses are mobilized. In other words, managers implement strategy by converting broad plans into the concrete, incremental actions and results of specific units and individuals.

Implementation control is the type of strategic control that must be exercised as those events unfold. Implementation control is designed to assets whether the overall strategy should be changed in light of the results associated with the incremental actions that implement the overall strategy. Prudential's updating of cost and revenue projections based on early experiences with regional home offices is an example of implementation control.

Two basic types of implementation control are:

?? monitoring strategic thrusts

?? milestone reviews

Monitoring strategic thrusts

As a means of implementing broad strategies, narrow strategic projects are often undertaken – projects that represent part of what needs to be done if the overall strategy is to be accomplished. These strategic thrusts provide managers with information that helps them determine whether the overall strategy is progressing as planned or needs to be adjusted. Although the utility of strategy thrusts seems readily apparent, it is not always easy to use them for control purposes. It may be difficult to interpret early experience or to evaluate the overall strategy in light of such experience.

One approach is to agree early in the planning process on which thrusts or which phse of thrusts are critical factors in the success of the strategy. Managers responsible for these implementation controls single them out from other activities and observe them frequently. Another approach is to use stop / go assessments that are linked to a series of meaningful thresholds (time, costs, research and development, success, etc.) associated with particular thrusts.

Milestone reviews

Managers often attempt to identify significant milestones that will be reached during the time a strategy is being implemented. These milestones may be critical events, major resource allocations, or simply the passage of a certain amount of time. The milestone reviews that then take place usually involve a full-scale reassessment of the strategy and of the advisability of continuing or refocusing the firm's direction.

c) Strategic surveillance

By their nature, premise control and implementation control are focused controls; strategic surveillance, however, is unfocused. Strategic surveillance is designed to monitor a broad range of events inside and outside the firm that are likely to affect the course of its strategy. The basic idea behind strategic surveillance is that important yet unanticipated information may be uncovered by a general monitoring of multiple information sources.

d) Special alert control

Another type of strategic control, really a subset of the other three, is special alert control. A special alert control is the thorough, and often rapid, reconsideration of the firm's strategy because of a sudden, unexpected event.

Table 2 summarizes the major characteristics of the four types of strategic control

TABLE 2: THE MAJOR CHARACTERISTICS OF THE FOUR TYPES OF STRATEGIC CONTROL [6]

Basic Characteristics	***Premise control***	***Implementation control***	***Strategic surveillance***	***Special alert control***
Object of control	Planning premises and projections	Key strategic thrusts and milestones	Potential threats and opportunities related to the strategy	Occurrence of recognizable but unlikely events
Degree of focusing	High	High	Low	High
Data acquisition	Medium	High	Low	High
Centralization	Low	Medium	Low	High
Use with:				
Environment factors	Yes	Seldom	Yes	Yes
Industry factors	Yes	Seldom	Yes	Yes
Strategy-specific factors	No	Yes	Seldom	Yes
Company-specific Factors	No	Yes	Seldom	Seldom

All four types of strategic control share common purpose: to asses whether the strategic direction should be altered in light of unfolding events. Strategic controls are designed to continuously and proactively question the basic direction of the strategy. Strategic controls are needed to manage the strategic process effectively.

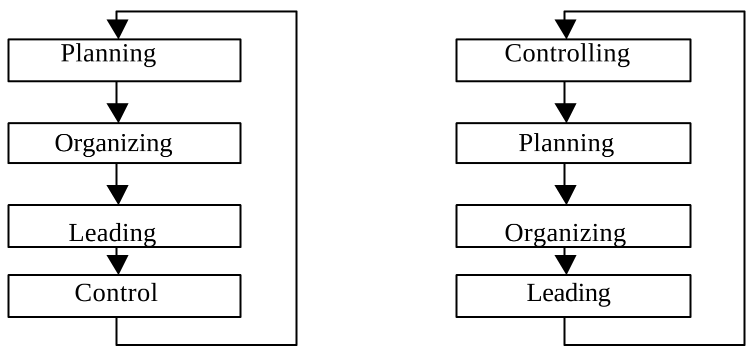
Moving Towards Strategic Controlling

Strategic control in the classical approach can be defined as, "the critical evaluation of plans, activities and rules, thereby providing information for future action". [5]

The limits of traditional control systems are overcome in part in a strategic control system by employing a feed-forward approach that is future-directed and anticipatory. “In its essence, engineering feed-forward control aims at meeting the problem of delay in feed-back systems by monitoring inputs and predicting their effects on outcome variables”. [1] Changes in internal and external circumstances need to be monitored on continuous basis and strategic direction evaluated critically in the light of those changing conditions.

“Controlling” as a term, which is contradistinguished from traditional “control” classified as one of main managerial functions. Traditional control is characterized as ex post control, and is classified as the last phase in management process. Controlling is first of all a preventive control and composes the starting point or the information source for planning.

FIG. 3: EX POST CONTROL AND PREVENTIVE CONTROLLING IN MANAGEMENT



Classification of controlling as a vanguard or a base for planning in the managerial process indicates its role and mission, which is derived form its priority orientation for identification and analyzes of problems and gaps, and searching for solutions.

Controlling is within the process of management focused on detecting problems, which occurs by realization of present plants due to internal and external factors. Relevant and early warnings and information providing by controlling and his reporting could be used at process of actualization of plans, still during planning period.

Prediction the future and the impacts of the factors in the future is a problem, which is still bigger and strategy and strategic management require to sensitively and carefully weigh the decisions, regard to existing risks, and searching and valuating existing alternatives.

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The Importance of Competence Management for Corporate Innovation

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Abstract

Statistics show that on the one hand innovative output in Spain is poor and on the other hand the changing environment (globalisation, enlargement of the EC etc.) requires intensive efforts to increase the innovative capacity. To improve the situation for Spanish companies a change process is necessary that tries to change the chip towards a culture of innovation. This means finally stepping into new markets with new products or develop new work processes. From a microeconomic point of view, the task is to create and foster competencies in the companies that help to develop an innovative culture. This means to manage competence potentials of the staff involved in innovation and to think about ways of learning and personnel development.

1. Introduction

There is no doubt about the importance of innovation for economic growth. In economic theory technological knowledge is introduced as a further factor in growth theory and also policymakers try to create business environments that are considered to be useful to foster innovation. The concept of national and regional innovation systems tries to coordinate the innovation process among the different innovation agents in a more efficient way. A critical point is the transfer of knowledge and technology in the system, in particular between the public sector, like universities and public research institutes, and the private corporate sector.[1] Technology Parks play an important role in promoting technology transfer. Figures show that most of the research in the most developed countries is done in private companies, about 76% in the United States, 69% in Germany and about 72% in Japan.[2] This shows that technology transfer, only seen as transfer from public to private organisations, plays a minor role. More important in this sense is the transfer within the private sector from private research institutes or companies to companies. Therefore, discussing the system and its efficiency means to discuss as well the efficiency of the innovation management in the private companies.

There is extended literature about the different approaches of innovation management. They analyse innovations from different point of views:

- ?? Studies about determinants of adoption and diffusion of innovations analyse the innovation process from the very beginning until its implementation and differentiate between two levels of aggregation. The adoption process refers to the individual that takes notice of the novelty, test it and adopt it. This incident always occurs independently from process or product innovations. The sum of positive adoption decisions describes the diffusion level of the novelty[3].
- ?? The evolutionary theory explains innovations as a result of competitive pressure and sees innovation as a tool to maintain the competitive edge and to assure the survival of the firm. In this sense, innovations grow endogenously as a corporate need.[4]
- ?? The description on the innovation process explains
    - o the different steps from the beginning (idea generation) to the end (market implementation)[5],
    - o the impact of decision making processes in the company on innovation[6],
    - o different types of innovation[7],
    - o resource planning and uncertainty[8].

These approaches explain the innovation process without spending too much time and space in analysing the aspect of competence. A research study, already done in the 60s and 70s at the University of Sussex, reflects among others also the aspect of competence and points out that knowledge is a central criteria of innovation success. The study, known as the SAPPHO-project, investigated success factors of innovation. The purpose is to find a positive relation between company characteristics and successful innovations.[9] The critical point is that innovation success seems to be easily reproducible once the company accomplishes with certain conditions of success, not taking into account that every company is its own world. The limitation of success factor research is shown by studies that focus on innovation barriers.

Reality shows that innovation policy is more than accomplishing with a list of critical issues. The starting point is that each innovation must be managed and that the core ingredient of innovation is competence. Instead of talking about technological knowledge as a component of innovation easily to handle, such as the growth theory is doing, this paper discusses in detail the aspect of individual competence and problems and ways of managing it in order to be innovative. The assumption is that by managing competence the company reduces organizational slacks, improve the transparency of internal processes and the assignment of human resources to innovation processes and, finally, improve the efficiency of the setting-up of innovations.

2. Key Factors of Innovation

Following the approach of national or regional innovation systems and taking into account the importance of the corporate sector, then each company should be considered to be a sub-system, whose innovative functioning has an influence on the innovative performance of the region or the country. Innovation analysis has to consider all those corporate activities that influence innovation and are usually described as innovation management.

The success of innovation depends basically on three factors that are related to the effectiveness of the operational innovation management: the market, the corporate configuration and the timing. If one of these issues is poorly managed, the impact of innovation on costs, market penetration and sales will be lower than possible. Operative innovation management is a central issue in achieving innovative sustainability because it marks behaviour and thinking, creates norms and conditions and, finally, institutionalises an innovative culture in the company. The underlying assumption is that the huge number of individual activities within a corporate organisation merge over time into a firm´s culture. If innovative capacity is a firm´s goal, operative management has to set institutional assignments that specify the norms of behaviour with respect to innovative curiosity and interest. Operative innovation management is successful when singular activities and events turn into a holistic culture of innovation. Although, two types of innovation can be divided, product and process innovation, the performance of the three factors mentioned above.

A new product cannot be launched successfully into the market, if it does not fit the market needs. To develop and produce a new product (product innovation) the company needs support systems such as technology and must involve the product development into strategic plans and tactical operations. As a future "star" in the company´s portfolio, an innovative product must be regarded as core element in the product range. Knowing the market and having prepared the internal configuration of the company, the time-to-market period can be reduced significantly, which is, within the competitive environment, a key element.

The same happens with process innovation; market, configuration and timing are crucial for innovative success. The market puts pressure on production processes, so that costs and quality have to be adjusted to market needs. The corporate configuration prepares the "grounds" to avoid innovation barriers in the company and the timing determines how fast employees are able to work in new processes and how fast new processes can be integrated into the already existing workflow.

The corporate configuration

It refers to the company´s unique personality that has to be carefully designed according to its strategic choices and managed properly in order to achieve a competitive advantage. Important aspects of the corporate configuration are:

- ?? Philosophy: The fundamental beliefs that unite the components of the company, enabling them to act as a whole.
- ?? Culture: Defines components and their relationship to each other. In this sense culture expresses a set of institutional norms.
- ?? Policy: Specifies boundaries on the design and prosecution of strategy, tactics, logistics and tasks.

The market

Innovation management is necessarily linked to market issues. Innovations are worth if they are driven by the customer value chain and, therefore, are business opportunities.[10] Something new that does not fit with the market demand is perhaps an innovation but without any market value and therefore without any economic benefit for the company. While the corporate configuration prepares the grounds to be innovative, the market evaluates if the innovation is worth it or not. This requires a deep understanding of what customers value in a product or service as "desired outcomes".

The timing

As a third element, the timing affects the innovative performance of a company. Two aspects must be considered:

- ?? The time-to-market span and
- ?? the first mover advantage.

The time-to-market span includes the time that is needed to transform an idea into a concrete product. This can be divided into four steps: market information, planning, implementing and commercialising. A long time span results in high development costs and includes the risk of bringing something onto the market that a competitor has introduced already earlier.

Being first, enables a company to gain valuable experience, create barriers and make the market entry for competitors more difficult.

To be successfully innovative, the company has to manage a set of activities that affect creativity and innovation and create an innovative atmosphere. These activities "situates individuals in collective contexts, where interaction is mediated through technology, language and symbolic artefacts"[11]. The activity theory points out that these collectives itself can create tensions and contradictions that are the origin of innovation and knowledge creation. This means that the source of innovation is, on the one hand, the market and, on the other hand, the corporate organization itself. The task of innovation management is to give space to creativity and novelty and to bundle and direct innovation capacity effectively and efficiently.

A reliable innovation management depends on individuals able and willing to work within an open and team oriented environment. Considering individual competence as crucial for innovation, a company with a low innovative output should analyse its human capital, the way how people behave and how they work together, before analysing market aspects or changing the corporate configuration. To be innovative, a company should be aware of individual competence and individual willingness to use the competence.

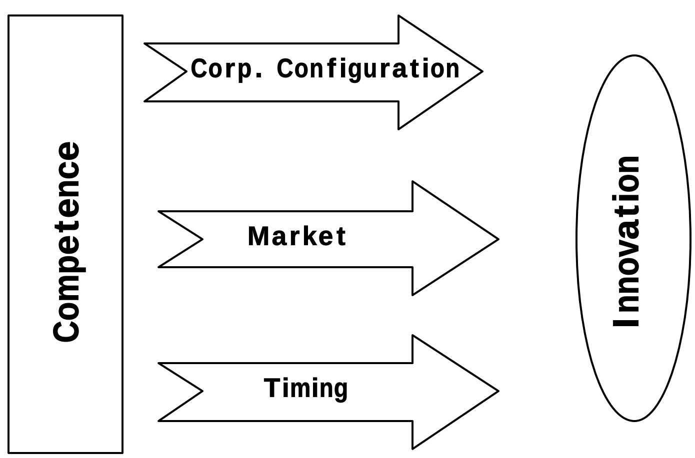

Fig. 1: COMPETENCE AND INNOVATION

3. A Pathological View on Individual Competence

As mentioned above, innovation depends on people’s competence, therefore, there should be special emphasis on the analysis and management of individual competence. But to manage competence means knowing the competence that is unified in the company. The following example about the implementation of a technological innovation underlines why it is important having an idea about what people can do or not do:

Imagine a medium-sized company which is threatened by its competitors and which start thinking about rising its efficiency by implementing a new machine in the company’s workflow. Managers and administrative staff travel around, visit trade shows and fairs, gather information and start calculating the costs. After some time a blueprint is presented to the top-management. The top-management accepts the proposal and a purchase order is sent out to the supplier. During the time of delivery the company carries out some reforms of the physical environment (junction, change in construction) to make sure that the new machine can be successfully integrated in the workflow. At this time people in the company take notice of some changes and curiosity rises. When the new machine arrives, expectations are high and people show a certain amount of enthusiasm. In such a situation, disappointment or frustration by managers as well as by the workstaff arises if they encounter problems in working with the machine. Finally, training is needed. This is the experimental phase, which means that the output that reaches the market is poor and that a lack of competence becomes visible.

Often, the implementation of technological innovation follows the same way that is described in the example above. Everything is planned, except the perhaps most important aspect, the intersection of employee and machine. What happens is that people experiment and try to check out how to work with it. It is a kind of arrangement between individual and machine and can be considered as self-learning, but nevertheless the company loses time and money. The result is an organizational slack. Such a reactive adaptation behaviour is caused by a wrong human resource policy or a lack of involvement on the part of the human resource department in the innovation process. This posterior adaptation process shows that employees are capable of managing situations that are beyond the routine and that their potential competence is bigger than their actually used competence.

A needs´ analysis of individual competence helps to avoid an expensive and time consuming process of trial and error. Global competitive pressure causes the factor time to become ever more important and correct planning and anticipation of problems in the production process is crucial for maintaining the competitive edge.

Talking about individual competence means, first of all, to define what we understand by this. In economics, psychology, sociology and pedagogy a lot of different approaches exist and different technical expressions like competence, capability, qualification, knowledge, etc. provoke conceptual confusion. Following White, Chandler and others, individual competence includes ability, knowledge and motivation.[12]

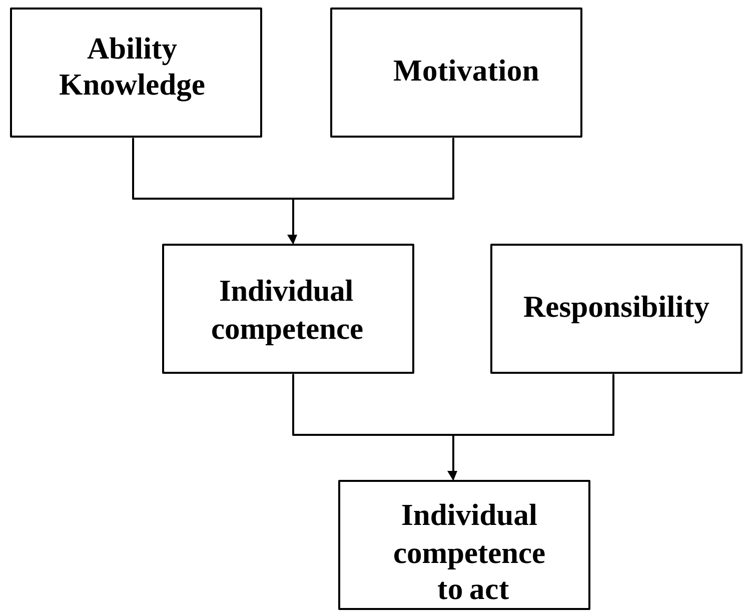

Fig. 2: COMPETENCE AND ACTION

Knowledge

Knowledge is the sum of accumulated information about reality, people, values, activities, etc. and is a condition for perception and behaviour. Nonaka introduced into the discussion the concept of tacit and explicit knowledge. His point is that there is on the one hand knowledge that can be systematically learned and transmitted by verbal communication (explicit) and, on the other hand, knowledge that must be experienced during the work process.[13] This differentiation is important because it shows the limitations of institutional training programs.

Ability

Ability is the sum of physical and psychic conditions used to carry out a certain task. Sometimes the individual is not aware of his or her abilities, because they are not frequently used. But such a "passive ability" can be recovered quickly if it should be needed.

Motivation

Motivation is the willingness of doing something. In case of technological innovation the employees should be open and interested in working under new conditions. Motivation is an essential prerequisite of using knowledge and ability. Individual competence depends on knowledge and ability, which become firm competence when the individual is willing to share his knowledge with others. Synergies through knowledge sharing create organizational competence that is more than the sum of individual competence.

Considering these aspects managing competence means to organize abilities and knowledge in a way that the individual can achieve his proper objectives and that the company can benefit from these synergies. The art of management is not to motivate people but to awaken their individual motivation by creating an environment (corporate culture) in which people identify themselves with the company. In this sense, motivation is an essential ingredient of competence.[14] In addition to this a limiting factor in the company is the responsibility which defines how far individual competence is usable in the company. Motivation as a limiting factor of the individual and responsibility as a restriction belonging to corporate decisions causes that the competence potential of the employees is bigger than the actually demonstrated competence.

In reality, a lot of things are not planned but spontaneously managed. This is, for example, the case when employees need to adapt to technological innovations without having previously had an introduction on how to work with it. Then, they have to find ways of spontaneous learning on the job. If this is unplanned, the employee uses his knowledge and abilities to adapt to the new situation. It is a kind of individual flexibility reserve and it is *this* flexibility reserve which keeps the process running.[15] People show that they are able to manage new situations that are beyond the routine by using their competence. A proactive human resource policy must identify this reserve and should consider it as one further starting point in the planning process of innovations. Innovations, then, are driven by the potential of individual competence. The difference, compared to the traditional approach, is that

1. the human factor is integrated in the process right from the beginning and not considered as a reactive variable and
2. that instead of actually used competence on the job, the potentially available competence is regarded.

This potential oriented approach reduces the implementation costs of technological innovations by planning the adaptation process of the employees and by knowing what can be carried out with the existing personnel.

Following this idea, the effectiveness and efficiency of innovation is strongly related to the management of competence. To reach a sustainable competitive advantage, based on productivity and/or product diversification, a company needs to invest continuously. Due to this, to be continuously innovative means to improve continuously the individual competence of employees and to manage it in an innovation oriented way. In this sense, personnel must be an integral part of innovation policy from the very beginning. It should be accompanied by a strategic and proactive human resource policy.[16]

Examples show that often companies do not make big efforts to manage competence in the company, even if they are aware of organizational slacks. The quality director of a Spanish automotive company with about 150 employees mentioned in an interview that there are a lot of unplanned processes and dynamics in the company and that improvisation is a common tool of management. In his opinion the level of control is low but, nevertheless, things are running well, because everybody knows his job. He stated that more than 90% of all orders are done in time. The company is aware of the importance of people´s skills but there are only few trainings, usually done by the providers, and knowledge management is almost inexistent.

Under stable conditions there is nothing to worry about, but the question is what happens if the environment changes and forces the company to react with internal or external adjustments. Are responsibilities still well distributed? Knowledge management helps to identify the capacity of a company to react and reduces reaction time.

Another problem that mentions a top manager from a Spanish sticker company with about 200 employees refers to the fact that, often, employees reject training programs. He sees this as a phenomenon that becomes worse from year to year. The consequence is that the implementation time of a new machine in the production process is sometimes longer than it was planned. In his opinion, this is something that goes ahead with the declining attitude of pro-activity and shows a lack of interest in work. This goes over into a lack of motivation and finally into a loss of competence.

These examples show that the reason for inefficient and ineffective innovation policies is a lack of managing competence, which includes the management of knowledge as well as the management of motivation. In this sense, individual competence is the central driver for innovation.

4. Competence Management as a Tool of a Potential-Oriented Innovation Policy

The question that arises is to become aware of that what the employees are potentially able to do. Focussing on knowledge and its differentiation, a crucial management issue is to motivate people to externalise their knowledge, especially their tacit knowledge, and that this knowledge is placed at the firm's disposal. The challenge is to find ways of:

?? incentivating employees to collaborate. "If people don't want to share, they are not going to do it even if you have the last technology in the world. People won't share if they don't see what's in it for them.” (Giovanni Piazza, Ernst&Young).

- ?? managing technically the amount of externalised knowledge and of
- ?? how to externalise tacit knowledge, which is highly dependent on the individual.

Due to the two types of knowledge, Nonaka identifies four different possibilities of knowledge transmission:

- ?? From tacit to tacit, which means, share experience and create new tacit knowledge.
- ?? From tacit to explicit, which is the sharing of tacit knowledge under the purpose of conceptualising and formalizing it.
- ?? From explicit to explicit, which is the creation of knowledge through classifying concepts.
- ?? From explicit to tacit, which converts explicit in tacit knowledge through learning-by-doing.

If the purpose of knowledge management is to make knowledge accessible, then management has to focus (a) on converting tacit into explicit knowledge and (b) on conceptualising and classifying explicit knowledge. The target objective is to have a structured base of explicit knowledge that results from a process of externalisation of knowledge. During this process, knowledge converts from individual into collective and becomes a visible competence of the company.

An important prerequisite of managing knowledge is the motivation issue. Talking about knowledge management means talking about the entire concept of knowledge and motivation.

In science and policy, a number of articles are published about knowledge management dealing with the problems of improving communication and storing knowledge, in particular tacit knowledge. Two different concepts of knowledge management are usually considered:

- ?? Personalization concept => managing the communication flow between the employees,
- ?? Codification concept => managing knowledge databases.

The personalization concept brings people together, creates networks and arranges an environment to support communication. The idea is that by linking people together, tacit knowledge can be shared. There is no central concept of externalising and sharing knowledge. It remains individual, but the employee is incentivated to share knowledge with others on a personal level. The workflow in companies using this concept is individualistic and very few standardized. These companies have highly customized products and services. Typical for this concept are flexibility and creativity to solve unique customer problems. The disadvantage of this concept is that the company does not really become aware of the knowledge potential due to the fact that there is no information storage. Consulting firms like McKinsey or Bain&Company are following this concept.

The codification concept codifies, steers, disseminates knowledge in electronic documents and allows its reuse. This IT-based strategy tries to separate the knowledge from the individual by a formal documentation system. Employees can benefit from information, experience, feedback, opinions and/or instructions from people working in similar projects without getting in contact with them. The advantage of the codification strategy is that even if the employee leaves the company, his knowledge or, at least, the externalised part of it remains in the company. This is important if we consider knowledge as an important asset of a firm. Disadvantages are the tendency of bureaucratisation and the problem of converting tacit knowledge into electronic documents. If the codification strategy means person-to-document, then more documents are circulating and more time is needed and more people are occupied only for managing this process. This can produce opposition and barriers to express knowledge.

Both strategies can also be used in common if a company´s business consist of creative as well as routinized work processes. Sectors that are highly competitive, where the life-cycle of a product is short, where the time-to-market period of a new product is short as well and where some work processes are being repeated, a combination of both strategies can be beneficial. The communication technology company Oracle is following this strategy. Based on the findings of Senge and Nonaka/Takeuchi, Oracle has transmitted academic concepts into practical management tools to increase its innovative capacity and keep playing a major competitor in communication technology services. Key issues are the management of employees´ knowledge through the creation of cross-functional practice communities. People from different functional areas come together, share their knowledge and work in project groups to generate new ideas or improve the workflow. Using Oracle´s technology these groups work together even if they are geographically located in different countries. The company´s Intranet portal enables employees to introduce and store knowledge into a commonly used data base, accessible for every employee all over the world. Apart from this, the portal is also used as a communication platform, where the diverse work groups (practice communities) have the opportunity of chatting among each other. Aware of different professional experience Oracle delegates responsibilities and distinguishes between:

?? The knowledge management sponsor, whose principal function is to coordinate and manage the activities of the practice communities.
?? The KM Lead promotes all activities related to knowledge creation. He is a mediator between the KM sponsor and the content provider.
?? Subject matter experts, who are experts in concrete web topics, like web cash.
?? Portal managers, responsible for the technical functioning.
?? Content leads, which are responsible for everything related to the content.
?? Content providers, which can be every employee of Oracle.

Based on a broad consensus the top management transmits his vision of the business to the lower management and gives support to innovation activities. KM-Management in Oracle is an integrated approach which combines aspects from the personalization as well as the codification concept and involves every employee in its KM by giving people a certain role. The combination of personalization and codification strategy is Oracle´s answer to market conditions that requires creativity, speed and a certain level of standardization. To make sure that people are motivated to contribute to the system, innovative contributions are economically rewarded.

5. Conclusion

The management of knowledge is an integral part of the innovation process and gives insight into the company´s knowledge potential. If the incentive structure or the organizational culture motivates people to share their knowledge with others, then, a first step is taken in capturing the competence potential of a company. As mentioned before, these reflections consider explicit and tacit knowledge as important objects of knowledge management but, without the individuals´ motivation to express knowledge, the whole knowledge management process fails. Knowledge and motivation create a company´s competence and must be managed. Competence management needs, in addition to knowledge management, the management of incentives. If this is done continuously, the company is informed at any time about the potential competence of its staff and is able to plan technological innovation on the basis of market requirements and people´s potential competence from the very beginning.

Increasing transparency of competence reduces organizational slacks, reduces costs and makes the company more efficient. Therefore, knowledge management which includes the issues of motivation and personal responsibility does not affect only the innovative capacity of a firm but is also a tool of effective cost management.

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Power and Games in Organizations

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Abstract

The bureaucratic organisation of the state once was classed as model of rational task fulfilling. Those contemplative times when the employees of the economy aimed their activities at the example of official however have long passed. The relations have nearly reversed. The public administration is learning from the economy. Today's examples come from the internal company management- and organisation theory. Being bound to rules and calculability - as in the bureaucracy theory by Max Weber - no longer are valid as guarantors of good administration.

Introduction

Rather today the once highly praised formal rationality of the public administration is regarded as hindrance for efficient and civil-friendly task fulfilling. The principle of constitutional state and principle of democracy face an example of the state as economic enterprise. What is shown are changes of the task perception as well as the management forms and the organisation construction. According concepts are being discussed since some time and in many places already applied.

In the past years the modernisation efforts on all levels of the public administration have spread "like wild-fire". The communities have advanced the most in the development; at least the reform efforts are examined, documented and promoted the most, while this is not (yet) the case to such an extent on national level.

After initial euphoria in the communities, however disillusionment and a consolidation has occurred. Reason for these manifold problems are reservations, fears and oppositions on all administration levels, as the employees regard the New Management Model (NSM) as a pure rationalisation concept and the Middle-Management fears a loss of status and power. This shows the "modernisers" that the realisation process of the concepts in the administration is as least as important as it's content. That is why "the micro-political processes of the participation of the employees in the work process and in the work situations of the public sectors gain significance".

The personnel representatives present a central acteur these processes, as due to their position in the administration they are to act to well being of the employees as well as the departments. For being able to effectively perceive the interests of the employees, beside defined legal tasks and rights for taking influenced, informal contacts and information are an essential factor. Which position influence possibilities of the personnel representatives take, depends on it's self-image, e.g. as modernisers or traditionalists and their co-operation with their social partner (e.g. department).

For this, service- or other agreements can be concluded by the actors, so-called rules, also for striving for a balance between rationalisation winners and – losers, with increase of efficiency and effectiveness of the administration action. However this requires a considerable split between the personnel and the economic aspects of the modernisation.

Micro-political starting point

Proceeding for the micro-political statement by Crozier/Friedberg (1993) among other the actor-referred analysis of the modernisation process is in the foreground. It's game concept is to serve as basis for the analysis, as it is "nearly ideal suitable for a actor-centred starting point, which wants to explain the structured, organised and interdependent acing of several actors in the federation". It is about the present these processes from the point of view of the actors (personnel representation and department management) and it's relation to each other.

The starting point of a "sociology organised acting" is to present a "realistic point of view of organisation", which equals a bureaucracy critic, which is independent of the actors handling.

Organisation form social constructs which are created and marked by the organised handling of it's members. Crozier/Friedberg present the opinion that an organisation only exists through the partial targets and rationalities which exist in the scope of acting individuals and groups and that an organisation not so much but rather exists despite the acting of it's members.

The strategic concepts, on which Crozier/Friedberg base their organisation analysis, are power, strategies and games.

For Bosetzky micro-politic is the effort to use system-own materials and human resources for reaching personal targets, especially of the advancement in the system itself and in other systems, as well a for securing and improving the own subsistence conditions.

For Neuberger the micro-politic means a collective name for all the strategies and games, which thereby come into question for bringing through own projects or preventing foreign ones. Small posts are to be occupied or to defend against arbitrariness or wanting to use useful chances; will (cannot) not always go the open lying way, but will see itself obliged to take detours, side paths, short-cuts or secret paths.

Power for Crozier/Friedberg is "the raw material of collective acting and therefore has to be in the centre of every serious analysis". To influence others means to get in relation with them, only through this the power of a person A can unfold over a person B. Therefore power is a relation and not an attribute of the actors. Power "basically is nothing else than the always contingent result of the mobilisation of the uncertainty zones of the actors controlled in a set game structure for their relations and discussions with the other participants in this game".

Power not at all is only to be seen negatively and repressively, but as basic aspect of every social relation. Every actor who wants to remain autonome, has to maintain space and with this his skills, his good will power, his behaviour regarding others uncertain. No situation in an organisation however puts an actor under pressure; he always keeps some freedom and negotiation elbow room.

Due to this elbow room every actor has power over other actors. The power is even larger, the more relevant the controlled uncertainty source by him for others is. So this means "Uncertainty of aspects of the problems, is power from the point of view of the actors".

Uncertainty, i.e. uncertainty regarding his concrete solution possibilities" can exist in two different ways: "Objective" uncertainties are brought up through the "technical, economical etc characteristics of these problems", while "artificial " uncertainties through the re-defining and re-structuring of the handling fields arise, for being able to work off and solve the games or negotiations.

Crozier/Friedberg make a distinction in four large sources of power:

1. Those which come from the holding in of a specific knowledge and the functional specialisation;
2. Those which are bound to the relations between organisation and it's environment, or rather it's environment segments (environment seaming point);
3. Those which come from the control of information- and communication canals (information control);
4. Finally those that arise from the existence of general organisational regulations (organisation regulations).
5. However the authors are of the opinion that these uncertainty sources not alone are derived from the power or even calculated. As everywhere exists a uncertainty source and it gains significance in the organisation processes only so far as the actors really use them when following it's strategies.

With strategies the actors follow their interests for reaching the targets. An actor on "rarely has clear targets and evenly less coherent and consistent plans; these are multitude, more or less significant in many ways, explicit and oppositional". They underlie multitude influences which before cannot be seen, through which constantly changes of acting and targets may arise, e.g. also in means becoming targets.

The target of the actor always remains active, also when it is always restricted and limited and can change in the course of his acting. His behaviour is always aimed at two sides, an offensive one which is marked by the fact that it is to lead to an improvement of the situation and a defensive one, which is to lead to his maintaining and extending of his freedom, that means of his acting ability.

Games not only refer to a harmless-easy playing, relaxed passing time or target- and interestless practicing and enjoying, but can also be "dead serious". Games in the organisations can also be: clever production, creative move and merciless competitions. Games present an essential instrument of the organised acting, which were developed by humans for regulating their co-operation.

Games combine freedom and compulsion with each other. The player remains free, but has to , if he wants to win, follow a rational strategy, which corresponds to the game and has to keep to it's rules. As long as the actors want to continue the game, they at least have to supply the necessary contributions and resources for the successful existence of the organisation.

Games are also marked through formal and informal rules, which also can be unnoted, changed or taken over by new rules or extended, with the target to maintain the relations between actors and to secure the participation in the game respectively the continuing.

Games are marked by the following characteristics:

1. Rules

   Here it is to be distinguished between object- and meta rules.

   Object rules characterise the concrete game (Chess has other rules than skat .

   Meta rules refer to the general behaviour like fairness, truthfulness, exactitiy, team ability, competition etc.

   It has to be made sure that the rules are known, accepted and kept to. Furthermore the rules have to be made known at the beginning of the game (activate) or agreed. The game can only commence, when explicitly or implicitly the rules were acknowledged/recognized. Regarding the keeping to the rules, often special institutions (referees, penalties, exclusion etc.). Agreed or known meta rules can also be laid down to which extent object-hurts (e.g. cheating) are tolerated.

2. Game situation and –material

   Beside the rules the game is also marked through concrete equipment. Here it is laid down, how the material game conditions are to be regarded (size and constituency, type of cards or figures or similar). It also has to be laid down, if the game is to be held before viewers or not. Rules and game constituency limit the game from daily situation respectively other games.

3. Time to play

   Beginning, end and time of the game can be determined before or made dependent of certain results. Also breaking conditions or the stopping respectively changing of single players has to be agreed.

4. Admission conditions and roles of the participants

   It is to be laid down under which conditions who is allowed to play. Thereby certain qualifications, performance documentations, personality characteristics (age, sex etc.), group membership etc. can be set. Also it can be determined that there are different roles and who is allowed to take them on respectively has to. The admission conditions can be called back, if lacking suitability, severe superiority, mis-behaviour can be noted, also they can be called back from just one side.

5. Target of the game

   The game target can also be fixed through general rules. Targets are e.g. the number of goals, to remain last or similar. However attempts have to be made to clearly determine the target of the game and inform all participants of this.

6. Result of the game

   Hereby it is about reward and penalties; they can either be material or symbolically or both, e.g. documents wins, exclusion etc.

7. Game tactics

   Games have to have a certain multitude significance. There are not to be any clearly determined action routines, with this the possibility arises to implicit the selection of proceeding, tactics and also the secrecy before the other players, they can be of different transparency. Strategies refer to the setting of whole game moves (e.g. aggressive, defensive, conventional, etc.).

   The named rules can without problem be transferred to “games in organisations”, mostly however not all listed aspects are used, but only the most important.

Organisation games can be divided as follows:

I. Games in which opposition against authority is made

1. Opposition games

   Here there are two versions, in one subtle opposition is made (miss-interpret , manipulate, undergo, exaggeratedly execute etc.), in an aggressive one open mutiny and rebellion arises (strike, sabotage, open disobedience)

II. Games against the opposition games

2. Conter-revolutional games

   Here the uproar (see 1) is fought against or stopped from the beginning. The typical bureaucratic way is to break opposition against authority with even more authority, e.g. with draconistic sanctions, strict surveillance or preventing controls. A political reaction would be to split the other side, to cut them off from information, to produce a multitude significance etc.

III. Games for creating power

3. Sponsor-protégé-game

   A person hangs on to an advancing person or to somebody who is already on top and shows loyalty as a return for a part of participation in power. The patrons fight for their protégé, place them strategically and give them the title of being powerful protectors.

4. Coalition-games

   These games are mainly only played under equally levelled, who make a net of relations with other persons in strategically important positions and with those persons who could supply them with resources (information or similar)

5. Area foundation game

   Single persons secure themselves a largest possible number of followers to extend their sphere of influence.

6. Budget game

   Here it is about establishing a position which one already holds. The target of the game is to reach more, whether it is positions, rooms, equipment, resources of any kind and especially financial means. The game however is highly formalised and known to all people using tactics; you always have to demand more than you need (because this in any case is cut percentually); you always have to prove things rationally, disguise the true situation, use up all means by the end of the year and similar.

7. Expertise-game

   Here an own specialist behaviour is exaggerated or played, inevitability and non-replaceability stated, knowledge played or kept back also extern experts are drawn.

8. Dominance game

In this game the own power is fully played or let out on others for scaring them.

IV. Games for fighting rivals

9. Line-against-officials game

   The officials often have information, which they can play against the line and they can try and dis-power them.

10. Rivalising-side-game

   This game if often the result of area foundations- and coalition-games. There are two fiendly sides, which fight themselves in nill-sum-games e.g. the “old gard” and the “new ones”.

V. Games for realising the organisational change

11. The strategic-candidate-game

   With strategic candidates not only persons are meant in who career hopes are placed, but also proposals, projects or similar. This game normally be divided through three phases: First a “candidate” has to be found, then he has to be sold as important respectively valuable and then brought through, for then self hanging on.

12. The tell-tale game

    If in an organisation a norm has been hurt, but this was to be kept secret respectively hidden, then insiders can use their knowledge i.e. pass it on to externals, for bringing them to intervene or the mobilise an opposition.

13. The young fake-game

    This game is an extreme version of the opposition games, hereby it is about a radical change. The existing power relations and orders are to be broken through a kind of state game. This game is often prepared by high ranked organisation members in secrete circles and leads to a revolution.

If you want to examine the way of functioning of the organisations a case study procedure is recommended, as the only possible starting point of such examinations can only be the attitudes and behaviour ways, short, the visible strategies of the organisation members. You have to try to connect the specific elbowroom of the organisation members with the resources and compulsion, through inductively reconstructing the structures, consistence and rules of the games, which regulate their co-operation.

Administration reform processes very well can be considered as games in the organisations.

Power: Uncertainties and their control

An actor gains power over other actors when he can control uncertainty sources, which are important of others. Uncertainties consist in administration reform processes (modernisation processes) in multitude way and type.

The most important uncertainty sources are the content creation of the concepts, their realisation and the implementation with the creation of acceptance. For the department managements also the personnel representations are a uncertainty source, as through their formal participation rights restrict the direction right of the employer and with this make the reform process more difficult or can even prevent this.

Through this the personnel representation as the control over an uncertainty source, namely the agreement of itself, under which you could class the fourth power source, if you regard the co-determination as an organisational rule. Furthermore the personnel representations can also control information- and communication canals, as the stand between management and employees and thereby can also take on a mediator role for both sides.

Bogumil/Kißler have distinguished between three types of basic action examples with the personnel representation: traditional, compensational and progressive form of the interest representation politic.

Traditional interest representations restrict on the status quo of securing the working conditions and to drive away new dangers. They do not develop an independent reform idea, the co-creation demand overstretches them and their participation practice on the reform field therefore is defensive. The compensating interest representation under-stands itself more as a mediator in conflict situations. As the working conditions are not regarded as problem field of the personnel representation work, they concentrate - more from the defensive – more on the reachable with the income- and employment politic risks of the reform idea. Progressive interest representations want offer the creation freedom, which the reform concepts as well as with the conception also still during the realisation, through an offensive participation practice use together with the base and to extend the contrary-power in the administration reform. They see themselves challenged and concipate own reform ideas or at least set the general conditions for the realisation of the reform ideas.

The personnel representation has the decisive task with the creation of acceptance or mobilisation of opposition against modernisations with the employees in the authorities.

The recognition of it’s significance in the modernisation process however does not automatically mean that they want to or can perceive these tasks, that means if they want to realise their power in action. This mainly depends on the attitude and targets of the different actors, which mark their action and with this their strategies.

Strategies: attitudes and targets

All actors follow strategies for following their interests, but which not always are clear and marked, but often diffuse, oppositional and sometimes not even conscious. With this they more move the attitudes and targets in the centre of the action of the actors, which due to manifold influences can constantly change.

Starting point or result of the following of strategies are the attitudes of the actors regarding the “game” administration reform.

I.e. that the actors have to adapt their strategy dynamically to the respective situation, also when principally follow a different strategy. The behaviour of actors with this always remains also free and not determined. The personnel advisors follow the strategies offensively and defensively at the same time, by trying to improve their and the situation of the employees in the administration reform processes without giving up their elbowroom or their action ability, but through this extend this.

However the relation of offensive and defensive mainly depends on action and the strategies of the social partners and the superior political level.

Games: Procedure and rules

The actors do not act fully isolated, but are also dependent of the acting of other actors and the dealing with each other. With this the games move into the centre of interest perception and the handling of the actors, by combining the freedom of self-acting with the obligation of "game rules" and of the strategies of other actors.

Decisive for the creation of the games are the attitudes regarding the respective social partner, which are presupposition but also result of the co-operation.

Very strongly dependent is the attitude on both sides of the respective experiences with the acting persons, which does not draw behind a general judgement of the social partner, but a differentiation according to the single persons. Thereby it is shown the more co-operative the respective social partner behaves, the more positive is the own attitude and the more successful the modernisation process is judged.

Game rules within the scope of the administration reform

Game rules are the other side of the freedom of the acting of the actors: they form the compulsion, which steers the games in structured ways and is to offer the security for participation in the games and for the arbitrariness of the others, as also can serve for the conflict regulation.

As game rules are to be named:

?? The holding of agreements based on common trust;
?? Information from the meetings are normally to be dealt as confidential until a official agreement has been made, the information of the other personnel advisory members however are not concerned by this ;
?? The personnel advisory takes part as full member in meetings and committee, i.e. he receives all information which the other participants receive;
?? Momentarily obligation with the decisions: The participating personnel advisory board normally cannot co-decide for the personnel advisory committee, but only for itself, i.e. the last decision therefore has to be made by the PR-committee;
?? For conflict avoiding in the committee an open discussion is made and problem solution in meetings;
?? Conflicts or problems firstly have to be dealt with in bilateral conversations between the social partners.

The progressive personnel advisory board has thereby to fulfil three role expectations:

?? As co-manager he is obliged from the point of view of the administration management, to support the result-open process in content, to approve of it, to secure the acceptance for the reform in the staff and to contribute to a most possible errorless realisation.
?? As moderator he becomes an important connecting person between department management and the employees, by judging targets and measures of the administration, to inform employees about this and to emphasise the steering group respectively the service department management the reform climate in the basis.
?? As interest manager he has to make sure of a balance between the administration- and employee interests. This in no way is simple, as the PR has to take up different interest situations of the employees and present, that means that nothing else but to use the winners and to protect the loser.

From this in the reform process the following effects respectively conflicts can arise:

?? In the perception of the staff the border lines between personnel representation and department are blurred; as the reform following can no longer be classed clearly to one or the other. This especially is the case with negative reform results (performance condensation, additional strain, etc.) as these (can be) lead back to the PV. It does not play a role if the leading back is acknowledged or not.
?? If the personnel representation becomes promoter of the reform, is may happen that the employees no longer dare to consult the personnel advisory board with their problems.

?? The personnel representation at the same time can also be a “general font of the critic” in the reform process, as it normally is the only instance which takes on the problems of the employees, i.e. the personnel representation can happen to become in the “centre” of the modernisation winners and-losers and the reform process as such.

Conclusion

Only through including of the actors can the deficits of the modernisation-processes remedied or prevent. That is why “the micro-political processes of the participation of the employees in the work process and in the work situations of the public sectors gain significance”. The personnel representatives present a central acteur these processes, as due to their position in the administration they are to act to well being of the employees as well as the departments. For being able to effectively perceive the interests of the employees, beside defined legal tasks and rights for taking influenced, informal contacts and information are an essential factor. Which position influence possibilities of the personnel representatives take, depends on it’s self-image, e.g. as modernisers or traditionalists and their co-operation with their social partner (e.g. department). Through an active participation in the decision committees the personnel representation can emphasise it’s demand on the co-creation and it can use the chances of the administration reform for improving the working conditions.

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Is Individual Management Style Variance Gender Dependent? A Case of Slovak Republic

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Abstract

The presented paper examines whether there is a difference in style in which female and male managers approach their subordinates. The study was conducted on a sample of 512 Slovak respondents working at all managerial levels. The objective is to identify whether there are any differences in communication, decision-making, delegation, and managerial style between male and female managers. The study is based on an analysis of attitudes of managers towards various aspects of their work; it does not examine how their subordinates view them. The results indicate that out of the managerial population, female managers make up 23.86% of the sample with greater participation in foreign companies than in local companies. Concerning the style of management, the study finds that female managers are more impersonal during formal communication in performance appraisal. Also they tend to delegate, empower, and trust their subordinates more than their male counterparts. However, there are no significant differences in the way both male and female managers approach decision-making.

Introduction

Countries of Central and Eastern Europe have had a long tradition of including women in workforce. During the communist era, the state planned economy required 100% full-time employment, thus both men and women had to play an active role in the workplace. The motto "everybody has aright to work" had gradually evolved into "everybody has the obligation to work". This has created different dynamics of the employment mode than could be noticeable in the countries where women only gradually started entering the workplace after the WWII, from the beginning opting for more flexible work arrangements such as part-time work. The gradual inclusion of women into the workplace asked for role clarification and even anti-discrimination acts. Even today, when women are actively employed in the USA and Western Europe (the proportion of women aged 16 – 65 is 67.1% and 54.9% respectively)[1], the majority of human resource management and organizational behavior textbooks discuss the issue of women at work as an issue organizations need to address.

Over the past decade, the significant socio-political changes in the Central and Eastern Europe have also caused changes in the employment mode that reflect women. Compared to the countries of Western Europe and the USA, there has actually been some withdrawal from active labor force among the female population in Slovakia[2] (54,0% in 1997 to 51,8% in 2001). Moreover, the career advancement opportunities are now made based on individual contribution and merit[3] rather than on political membership, which had been the career advancement prerequisite before 1989. There has been an increase in the number of women entering into managerial positions, yet that does not mean that they are given the same opportunities or that they are rewarded the in same way as their male counterparts[4].

Numerous studies (of mostly Anglo-Saxon provenience) have focused on gender differences and their impact on managerial style, discussing who is abetter leader or amanager or analyzing how men and women approach different managerial situations. A study by Powel, Butterfield and Parent[5] shows that a good manager is still viewed by both males and females as possessing predominantly masculine characteristics. It is so despite the continuous increase of female presence in managerial positions. Thus, women need to portray themselves in a way that is consistent with masculine characteristics such as competitiveness, ambition and assertiveness. Nelson and Quick[6] state that women leaders are more likely than men to include and energize people, helping them feel important. Yet, as managers they may be less effective when it comes to delivering negative feedback to their subordinates. Atwater, Carey and Waldman[7] found that women are perceived to be less fair and less effective when disciplining their subordinates. They attribute this mainly to biases from subordinates but also to the differences in behavior of female and male managers. When assessing performance, women tend to act on a basis of equality and are thought to be less sensitive to the causes of certain type of performance. Thus, if the performance is poor they tend to punish it equally regardless of cause, whereas men would investigate and differentiate among poor performers[8]. A study by Statham[9] shows that female managers focus more on tasks to be accomplished and interacting with their subordinates while male managers are more engrossed by themselves, emphasizing the power they have. According to Calhoun and Smith[10], women, contrary to men, enter negotiation settings with higher concern for the other's outcomes. All these studies suggest that female managers demonstrate more empathy and collaborative attitude in the style they handle people, yet when it comes to focusing on goals and performance they accept a stricter role.

Most studies attribute the differences between male and female managers to the process of socialization that starts in early childhood and determines the values, attitudes and beliefs of people. The "proper" roles in society are developed in family through reinforcing certain behaviors, through fairy tales and/or religion. The majority of fairy tales are governed by kings and the best recognition girls can hope for is getting married to (or rather being given to as a reward) a smart, courageous prince who has just saved the kingdom. Observing their parents, family members and friends further strengthens the stereotypes that young people gain. If, for example, the children are used to seeing their mothers go to work every day and hold professional positions within organizations, then the girls would take it as "normal" to aspire for professional full-time positions and boys would find it "normal" to have female co-workers and superiors.

From the early childhood, men and women are socialized differently, expecting men to be competitive, assertive, and courageous while leading women to be more sensitive, warm, supportive, submissive, and passive. People build their expectations on what roles men and women should play in the society and how they should behave in their roles. In this, national culture plays an important role in forming the attitudes towards many aspects of working life. The culture that is more egalitarian would place fewer barriers for women to enter managerial positions and in such an environment women would understand their options and opportunities. In egalitarian environment, women would make choices voluntarily and would perceive fewer outside barriers to their decisions.

In the region of Central and Eastern Europe, the period of communism that lasted over two generations has introduced compulsory employment mode for both men and women. Women have taken professional positions, however, their access to leadership positions has been constrained. Also, in line with Anglo-Saxon literature, there is a difference between typically male and typically female jobs[11]. Female type occupations have less prestige, less power and make less money than male type occupations. Women also do not frequently hold executive positions in organizations or high-ranking political positions and generally it is thought that women need to show more effort in order to break the glass ceiling and make career advancement.

Thus drawing on theoretical concepts and the specifics of the environment, the aim of this study is to determine whether there is a difference between male and female managers. As the role of a manager is perceived as masculine, we believe that female managers would need to balance their focus on people and goals with an aspiration to be perceived in line with the masculine role. Based on the other studies, we believe that female managers will be more involved in both dealing with subordinates, trusting them and achieving goals through an consultative approach. On the other hand, we believe that when it comes to formal interactions during performance appraisal, women will try to accommodate the role of a critic in restricting to formal evaluation of goals and keeping the relationship neutral by focusing on the evaluated person. This can serve as a shield from being seen as unfit for a managerial position. Thus, we formulate the following hypotheses:

H_1: Female managers will show stronger tendency to delegate and empower in their managerial style then male managers.

H_2: Female managers will show stronger inclination for consultative decision-making style then male managers

H_3: In assessing performance, female managers will show more equalitarian approach in dealing with their subordinates

Questionnaire and Research Sample

The questionnaire consisted of three parts. In the first section, we asked for demographic data such as gender, the managerial position of the respondent, ownership of the company, seniority, and age of respondent. The second part consisted of 30 statements that the respondents had to evaluate on a five point Lickert scale and the third section offered statements with a range of answers. In the third part, the respondents could give multiple answers with which they agreed. For the purpose of this study, we focus the analysis only on those questions that directly or indirectly deal with aspects of managerial work, such as delegation, empowerment, communication, decision making and managerial style and analyze and compare data for each subgroup.

The total number of questionnaires sent was 718. They were sent to 52 companies with a final count of returned, filled-out questionnaires amounting to 512 from 35 organizations. This represents a 71.31 % return rate on individual participants and 67.3% on the companies. The enterprises actively involved in the research cumulatively employ 11,765 people. We consider this sample sufficient for an analysis.

The demographic characteristics of the respondent group were as follows. There were 115 (22.55%) top managers, 205 (40.2%) middle managers, and 190 (37.25%) line managers. The group consisted of 390 (76.32%) male respondents and 121 (23.86%) female. Out of the sample, 64 (12.52%) were younger than 30, 190 (37.18%) were from the group 31 – 45 years of age, and 257 (50.3%) people were older than 45. There were 432 respondents from Slovak companies and 72 from those with capital investments from abroad. There were 13 foreign companies and 22 Slovak companies represented in the sample. The most frequent number of direct subordinates was four, indicating a rather narrow span of control. The extreme numbers of direct subordinates, however, ranged from 1 to 135. There were 511 respondents who identified their tenure, out of which 33 (6.46%) have worked less than one year for a company, 101 (19.77%) who work 2-5 years with the company, 123 (24.07%) who work 6-12 years with the company, and 254 (49.71%) who work longer than 13 years with the company.

The respondents in the survey were exclusively in managerial positions and regarding their particular style of management, there are no responses gathered from their subordinates. Thus the possible gender differences are of self-evaluative nature and would represent the managers' understanding of their role and job, their attitudes to goals and the people they manage. As attitudes influence behavior, we believe that these self-descriptions and statements of preferences in style of management are sufficient to draw conclusions on the style on management executed by the respondents.

Analysis of Female Representation in the Sample

There were 121 female respondents in managerial positions participating in the research. Ninety-five of them (78.51%) were employed in local Slovak companies and 25 (20.66%) were employed in foreign companies (for detailed demographic data see Tab 1. and Fig 1.). When *compared* to male managers, the female group represented just 21.99% in Slovak companies and a bigger portion (31.65%) in foreign companies. Generally, compared for each subgroup individually, there was a tendency to see more female managers among a younger age group – people younger than 30 years of age (with 35.94% of the age group) than in older groups where female managers made just over one fifth of the particular respondent group. The proportion of females also increased with decreasing tenure – even though low tenure groups had generally smaller number of respondents than the groups of managers with more years spent with the organization. In terms of managerial position within the company, the strongest representation of females was in middle management position, although when compared by age and position, most top managers are among younger women (relative to their male counterparts) and middle and line managers are on the contrary older employees. However, we can observe an interesting staffing difference when we compare the ratios of female/male representation in managerial positions in Slovak companies and in foreign companies (for more detail see Table 2.). Actually, the proportion of females increases with position in foreign companies, from 27.27% in line management to 39.13% in top management, and in every category it claims larger share than proportion of females in any given category in Slovak companies. In Slovak companies, the largest proportion of female managers is in middle management positions (25.73%). The biggest gap in female managerial representation can be observed in top management positions in Slovakia, where the female representation is just 16.30%. Moreover, very few young women (under the age of 30) can be found in Slovak companies – total number of five, while the numbers of young female managers and young male managers are balanced in foreign companies, 18 and 19 respectively.

TABLE 1. COMPARISON OF FEMALE/ MALE DEMOGRAPHICS

		FEMALE **(121; 23.63%)**	MALE **(390; 76.17%)**	TOTAL **(512; 100%)**
Slovak		95 (21.99%)	336 (77.78%)	432 (99.87%)
Foreign		25 (31.65%)	54 (68.35%)	79 (100%)
Top management		24 (20.87%)	91 (79.13%)	115 (100%)
Middle management		54 (26.34%)	151 (73.66%)	205 (100%)
Line management		43 (22.63%)	147 (77.37%)	190 (100%)
Age	less than 30	23 (35.94%)	41 (64.06%)	64 (100%)
	31 – 45	40 (21.05%)	150 (78.95%)	190 (100%)
	45 and more	58 (22.66%)	198 (77.34%)	256 (100%)
Tenure	less than 1 year	13 (39.39%)	20 (60.61%)	33 (100%)
	2 – 5	35 (34.65%)	66 (65.35%)	101 (100%)
	6 – 12	25 (20.33%)	98 (79.67%)	123 (100%)
	13 and more	48 (18.90%)	206 (81.10%)	254 (100%)

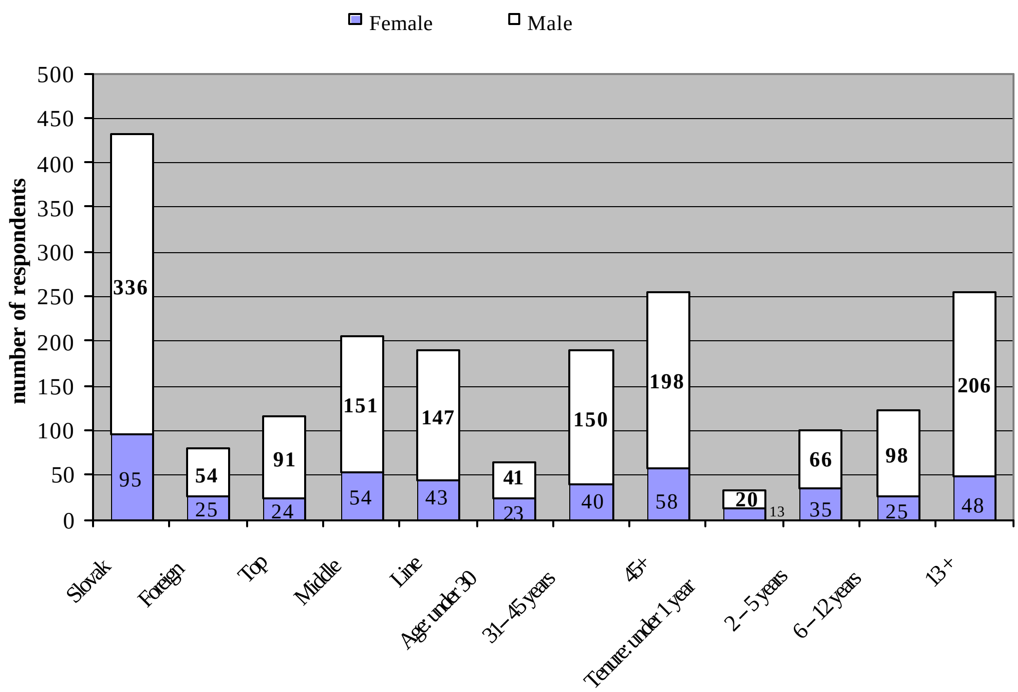

FIG. 1. VISUAL COMPARISON OF THE FEMALE/MALE DEMOGRAPHY OF THE SAMPLE

TABLE 2. COMPARISON OF GENDER DEMOGRAPHICS IN SLOVAK AND FOREIGN COMPANIES

	SLOVAK		FOREIGN	
	Female	**Male**	**Female**	**Male**
Top management	15 (16.30%)	77 (83.70%)	9 (39.13%)	14 (60.87%)
Middle management	44 (25.73%)	127 (74.27%)	10 (29.41%)	24 (70.59%)
Line management	36 (21.56%)	131 (78.44%)	6 (27.27%)	16 (72.72%)
less than 30	5 (18.51%)	22 (81.48%)	18 (48.65%)	19 (51.35%)
31 – 45	33 (20.75%)	126 (79.25%)	6 (20.00%)	24 (80%)
45 and more	57 (24.26%)	178 (75.74%)	1 (8.3%)	11 (91.67%)

Questionnaire Analysis

Due to the nature of collected data, we have decided to test the Hypothesis 1 and Hypothesis 2 by analyzing the collected data in a two-step approach. First we have clustered related responses and then conducted the analysis of clusters using the Frequency Procedure, followed by the Chi-Square test and checking for Phi Coefficient to determine the significance of relationship between the clusters of data. We have used this analysis for the responses in the second part of the questionnaire with statements that were to be evaluated on a five point Lickert scale.

To test the Hypothesis 3, we have used a simple analysis in questions that could not be clustered and that analyzed performance appraisal.

Data Clustering

For the purpose of analysis, we have clustered the questions from the second part of the questionnaire by grouping the related responses together into 4 clusters; delegation, empowerment, decision-making and managerial style. These categories capture the basic concepts of managerial work and to further understand the approach to managerial work, we have also compared the pairs of clusters. The clusters separately would suggest the attitudes of managers towards their subordinates and how they perceive their own work, however if there is a relationship among the couples of clusters then the particular tendency is reinforced.

For the purpose of this study to *empower* is to pass decision-making to others. Within an organization, this often means passing the decision-making to a lower level of the hierarchy; it encourages initiative and responsibility of subordinates and reflects a level of trust towards the subordinates. An "empowering" manager, with a controlling role, is involved only when work is finished, yet he/she is perceived as open to help when needed. The cluster *delegation* depicts the managerial concept of assigning tasks; it is a part of day-to-day work and stems from the formal authority of the respondent. This cluster reflects the attitude of the respondents both towards their subordinates and the assigned goals as well as the attitude towards receiving assignments from their superior. In this cluster, we have included such questions dealing with the everyday practice of assigning as well as controlling tasks, the level of independence and formality of the style of managers towards their subordinates. Delegation also reflects initiative/passivity in the relationship between a manager and a subordinate. The next set of clusters that we have analyzed dealt with the way respondents approach decision making and analyzing what are the respondents' attitudes to their job. Thus the cluster *decision-making* deals with the degree of consultative style in decision-making. The decision-making cluster focuses on the degree of consultation and involvement of subordinates in the process rather than judging the nature of the decisions managers make. This cluster also examines whether the respondents are being consulted by their superiors and whether they perceive they are involved in decision-making. The cluster *"Managerial style"* addresses the general perceptions of the respondent as to what is expected from them and what is the role a manager. This cluster reflects the values of respondents that underline their overall managerial style how they view their relationship towards their superiors as well as subordinates and whether they are interested at all in learning how their subordinates perceive them.

In each cluster, the answers around the values of '1' and '2' indicate that the respondent does not agree with the particular statement, answers around opposite values of '4' and '5' suggest agreement with the statements –

and in this particular analysis, high responses show open communication and trust, more empowerment and more flexibility. In each cluster, there is a [control] statement that can be considered opposite to the others, so the responses were logically inverted. In order to cluster the responses, we have reversed the numerical values so if the answer was '5', we have assigned it '1', if the answer was '4' we have assigned it '2', and so on.

Following, we have computed the responses and assigned values '1' (never) through '5' (always) to the whole cluster according to the following key. If there are 4 questions in a cluster, then sum of answers in value '4' -- '5' is assigned value '1'; if there are 6 questions in a cluster, then sum of answers in value of '6' – '8' is assigned value '1'; and so on (for an illustration, see table 3). It is possible to consider the assigned values representative of the clusters.

TABLE 3. ASSIGNING VALUE TO CLUSTERS (EXAMPLE)

EMPOWERMENT (4 questions)		**EMPLOYEE DELEGATION (6 questions)**	
Sum of responses from Lickert Scale	Assigned Cluster value	Sum of responses from Lickert Scale	Assigned Cluster value
4-5	1	6-9	1
6-9	2	10-14	2
10-14	3	15-21	3
15-18	4	22-26	4
19 - 20	5	27-30	5

In the second step, we have analyzed the clusters using first the Frequency Procedure to see what is the co-dependence between the clusters. Then we have tested the results through Chi-Square test, the probability of which should be <0.05 to be considered significant; and Phi Coefficient the value of which should be >0.5 to show significance.

When comparing total data of the clusters *employee delegation* and *empowerment* we have seen strong relationship between the two on the values of '3' (usually) and '4' (almost always), when 346 responses of value '3' in *employee delegation* have been divided between value '3' and '4' in Empowerment, 166 and 180 respectively. Both Chi-Square probability and Phi-Coefficient value show significance (see Table 4). Overall, this shows moderate, yet positive, tendency of managers to delegate assignments and responsibilities to their subordinates and to empower and trust their employees, the respondents tend to believe that their subordinates are independent, can be trusted with decisions (albeit more with routine than with non-routine ones) and generally, they both provide and receive quite large autonomy in their work.

When separating the data into the subgroups of male and female managers, we can observe a significant difference in the responses. Phi-coefficient shows value of 0.9352 (and significance) and is an indicator of co-dependence in the sample of female managers. Seventy-eight of the respondents assigned value '3' for Delegation that they split for values '3' and '4' in *empowerment*, 43 and 35 respectively. This suggests that there is a relationship between the level of trust female managers exhibit towards their subordinates and the degree to which they engage their subordinates. Data shows that female managers delegate the routine decisions on their subordinates and that the subordinates do not need to be constantly monitored, leaving them greater autonomy, yet are approachable when subordinates need help or assistance. They also indicate that their subordinates do not hesitate and seek advice or assistance from their manager.

On the contrary, the data of male managers show Phi-coefficient 0.3524 which means there is no significance in the relationship of the two clusters and that their preference towards either empowerment or delegation cannot be predicted by either dimension. Still, the largest number of responses (268) gathers at value '3' in *delegation* split between values of '3' and '4', 123 and 145 respectively. This suggests that male managers also prefer to let routine decisions to be made by subordinates and that their subordinates do not expect that they are passively told what to do. However, the degree to which they do let subordinates work independently does not suggest the level of trust they demonstrate towards their subordinates.

These results support Hypothesis 1 that female managers would use empowerment and delegation more as a part of their managerial style than their male counterparts.

TABLE 4. CHI-SQUARE AND PHI-COEFFICIENT VALUES FOR ANALYZED CLUSTERS

	EMPOWERMENT/EMPLOYEE DELEGATION	
	Chi-Square Probability	**Phi Coefficient Value**
Total data	<.0001	0.6377
Female managers	<.0001	0.9352
Male managers	<.0001	0.3524

When comparing total data of the clusters *decision-making* and *managerial style* we have seen strong relationship on the value of '3' (usually), when 333 responses of value '3' in *decision-making* have also circled value '3' in *managerial style*. Another 37 respondents have indicated value '4' (almost always) in decision-making and value '3' in managerial style. However, these are rather careful expressions of respondents and the Phi Coefficient does not show support for the relationship between the two sets of clusters, as its value should be bigger than 0.5.

From previous analysis, we have come to the conclusion, that generally the managers are both goal-oriented and people-oriented – they stress the importance of achieving results and taking care of the subordinates, being interested in their personal problems when assessing performance; and the orientation was stronger for female managers than for male managers[12]. However, this analysis does not show significant relationship between the style of management and preference towards decision-making (Table 5). Phi Coefficient for neither female managers nor male managers shows significant relationship, even though the female group shows a slightly larger co-dependence of the two clusters. Most responses of female managers are grouped in the value of '3' for both clusters (76 responses out of 121) indicating that the respondents believe their relationship with their subordinates (as well as their superiors) is professional and friendly. The respondents also demonstrate interest in learning what their subordinates think of their actions, and they balance their understanding of the needs of subordinates with achieving goals.

These results only partly confirm the Hypothesis 2 that female respondents would be more consultative in decision-making. While, the tendency is stronger for women than men, it is not significant enough to draw satisfactory conclusions.

TABLE 5. CHI-SQUARE AND PHI-COEFFICIENT VALUES FOR ANALYZED CLUSTERS

	DECISION-MAKING/MANAGERIAL STYLE	
	Chi-Square Probability	**Phi Coefficient Value**
Total data	<.0001	0.26
Female managers	<.0091	0.4256
Male managers	<.0234	0.1702

A job of a manager comprises two roles: formal and informal. The way people behave in these roles might change and while some managers can be friendly yet strict and professional, other managers are biased, favoring those whom they like (similar-to-me error) or exhibit cowardice or are unable to give negative feedback (leniency error). Concerning managerial style, we believe that it is also important to examine the formal part of managerial communication represented in a form of performance appraisal. Thus we have examined what are the attitudes of managers towards a performance evaluation session, whether they believe it is motivational and what is their understanding of the manager's role during performance appraisal. Performance appraisal is a formal part of interaction between managers and subordinates, it involves at least assessing past work performance of subordinates and often it includes also the setting of further goals or designing training and development programs. If it is to be motivational, it is necessary it to be impersonal, factual, objective and executed in a timely way[13].

In Slovak companies, performance appraisal is in some form regularly performed[14], however we also wanted to know what is the individual [subjective] understanding of the function and how the managers understand their "ideal" role during the session[15]. So the question in the questionnaire was stated hypothetically (see Table 6). In this part of the questionnaire, the respondents could indicate more than one correct answer and thus portray themselves more clearly. Generally, both male and female managers believe that performance appraisal can be motivational and most of them agreed that they should evaluate the subordinates in a factual, non-biased way. However, there is a difference between male and female managers when it comes to what extra information a manager should be interested in. More female managers indicate that their role is to provide subordinates with both positive and negative feedback (although male managers also strongly indicate this response). The interesting difference is in the need of the managers to show interest the their subordinates' personal problems and in their relationships at the workplace. Male managers show a stronger desire to investigate their subordinates' personal problems and express the need to understand the relationships of their subordinate (the value here is almost double that of female managers). The reason why female managers focus on "hard" objective data might be that they do not want to give the ratees a reason to complain about bias and they want to give a perception of procedural fairness. Focusing on goals and evaluating in a factual way may support the sense of justice and also may be a way for female managers to accommodate the masculine role with which the job of a manager is frequently associated. The preference to give both positive and negative feedback can even underline the feeling of impersonality, yet fair treatment. It is interesting to note that it is male managers who try to be more personal, understanding and exhibit willingness to learn about personal lives of employees.

Hypothesis 3 is supported and we can conclude that female managers exhibit more egalitarian, impersonal approach when formally assessing their subordinates.

TABLE 6. PERCEPTION OF MANAGERIAL ROLE DURING PERFORMANCE APPRAISAL

IN YOUR OPINION, DURING PERFORMANCE APPRAISAL EVALUATION, THE MANAGER SHOULD*		
	FEMALE **(N =121)**	MALE **(N = 390)**
a) evaluate goals	14 (11.57%)	36 (9.23%)
b) show interest in personal problems of subordinates	9 (7.44%)	45 (11.45%)
c) evaluate matter-of-factedly	76 (62.81%)	278 (71.28%)
d) show interest in the relationships among subordinates	13 (10.74%)	77 (19.74%)
e) provide both positive and negative feedback	52 (42.98%)	150 (38.46%)
I CONSIDER PERFORMANCE APPRAISAL TO BE A MOTIVATIONAL FACTOR		
Never	2 (1.65%)	7 (1.79%)
Rarely	8 (6.61%)	18 (4.62%)
Sometimes	16 (13.22%)	40 (10.26%)
Usually	35 (28.93%)	133 (34.10%)
Always	60 (49.59%)	192 (49.23%)

* the respondents could mark more than one answer

Discussion and Limitations

The presented paper discusses gender differences in managerial style. The research is based on the respondents' own responses, so there is no subordinates' perception of the actual style of the managers. This is actually a self-portrait of the respondents and as such it indicates the differences in priorities and understanding of managerial role of female and male managers. The beliefs and assumptions lead to behavior, so it is safe to predict that reported differences in style of management are also demonstrated in actual behavior of the managers. However, in the future it will be useful to design a study that would examine the beliefs of managers and perceptions of the subordinates and seek to portray managerial style from the side of those who are managed to confirm the self-perception of managers.

Generally, we can conclude that there is a degree of female under-representation in managerial positions. When compared to male managers solely, women make up one third in foreign companies and only one fifth of managers in local Slovak companies. When compared to the percentage of females actively working the disparity is even larger.

Female managers as a group in the sample were younger women with lower span of organizational tenure. Foreign companies show a better balance in promoting women into managerial positions than local companies; however, this may be also an indicator of the unbalance of the industries in the sample: most local companies in the sample operate in the production area (chemicals, engineering, metallurgy) or transportation and these are usually male dominated industries.

Upon analysis, we can conclude that female managers use participative style of management, trusting their subordinates and letting them work independently, yet they are more open for consultations than their male counterparts. While male managers also demonstrated a tendency to delegate and empower their subordinates, there was no significant link between the two aspects of managerial style. This makes male managers less consistent in the way they manage their subordinates. They may actually be more distant from the employees, yet they still maintain professional and friendly relationship with their subordinates. On the other hand, female managers hold a more impersonal stance when engaged in the formal role of assessing the performance of their subordinates. It is the male managers who believe that during performance assessment, a manager should be interested in personal lives of his subordinates and their interpersonal relationships at the workplace. This can be for two reasons: 1) female managers may not believe this is important during the performance appraisal because they separate formal communication from informal one and thus believe it is not appropriate nor professional to mix personal with formal assessment, they may fear that they would be judged by their subordinates as favoring certain people or not being fair; 2) female managers, thanks to the cooperative style of management, already know their employees well and want to fit the masculine role of a manager that requires them to be a fair judge during performance appraisal. In any case, focusing strictly on work performance can be a drawback as it may make it difficult for female managers to provide the employees with training and development programs to improve in the future or to eliminate problem spots within a team of employees.

Conclusions

From the presented analysis, we can conclude that gender is a variable in defining managerial style. The style of female managers is more co-operative and consultative, female managers tend to delegate and empower more than their male counterparts. On the other hand, when engaged in formal evaluation, female managers believe they need to be judging solely the performance of the employees and do not find it relevant to inquire about private problems of their employees or about their relations with other colleagues. They prefer to remain neutral when evaluating others and providing them with official feedback. When comparing preference of decision-making style of male and female managers, data does not show significant difference between the two groups.

It can be concluded that in the environment where women have a tradition of active employment but where they just recently started to assume managerial positions and working in the external environment that is changing rapidly, female managers assume a more formal, impersonal attitude when engaged in assessment and evaluation of their subordinates but they are trusting and empowering managers. There is still a dual attitude of female managers, differentiating between everyday, more informal situations in which they are cooperative and open to their subordinates and the formal settings during which they tend to assume the “masculine” role of a strict, goal-oriented manager.

End Notes

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Cross-Cultural Management in International Companies in Central-Eastern Europe: Case of Slovenia and Slovakia

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Abstract

Central European countries enter the second decade of their transition. During the 1990's all Central European countries took great strides in establishing functional democratic systems and integrating themselves politically and economically with the rest of the world. There were major accomplishments in the complicated process of economic restructuring and Central European economies' integration into world markets. Some of the economies experienced growth after recession, but some of them are still in a developing stage. The entry of foreign companies, either as joint ventures, or as 100% investments, is among the measures that may lead to recovery. As all of them must rely on local workforce, totally or partially, they face the problem of intercultural management, which is becoming a central issue for the managerial practices in operative FDI in Central-Eastern European countries. The diversity of values, attitudes and approaches between expatriates, who usually cover higher organizational ranks in the international company, and locals, may be a sizeable danger to development. It could provoke internal conflict situations, leading to negative business results and even to failure of international operations. There could be two types of problems: the endogenous one, i.e. the problem of intercultural diversity management within the company, and the exogenous one, regarding the relationships between company management and the local environment. Therefore, we would like to investigate, whether the effort of recognizing and facing such kinds of conflicts, can be, in the first place, managed, and, in the second place, even exploited in order to create a competitive advantage for the company. Our research will attempt to find out what is actually happening in the European joint ventures in Central-Eastern nations. In other words, do they recognize the problem, do they manage it properly, and are they able to transform it in an opportunity?

Introduction

In order for the transitional process of Central European Countries to be successful, it is essential that large, previously state-owned socialist companies learn to operate under the newly – created market conditions. With the entrance into the EU, and as a consequence of the global situation, the area of Central-Eastern Europe[1] is destined to grow in importance. It is an evaluation of the world scenario that does not appear as exaggerated. If we look at the world situation, we can see that the Middle East has problems to live with what is known as "modern" culture[2]. The same thing may be said for South America, though in this second case the "cultural gap" seems less severe. The Far East is probably the only non-Western part of the world, which keeps pace with the development. But, even there some preoccupations emerge, such as deflagrations of integralist origin, extending their tentacles also to this direction, difficulties of financial recovery, civil rights, and the like. Furthermore, Africa is an area of the world that is especially difficult to evaluate.

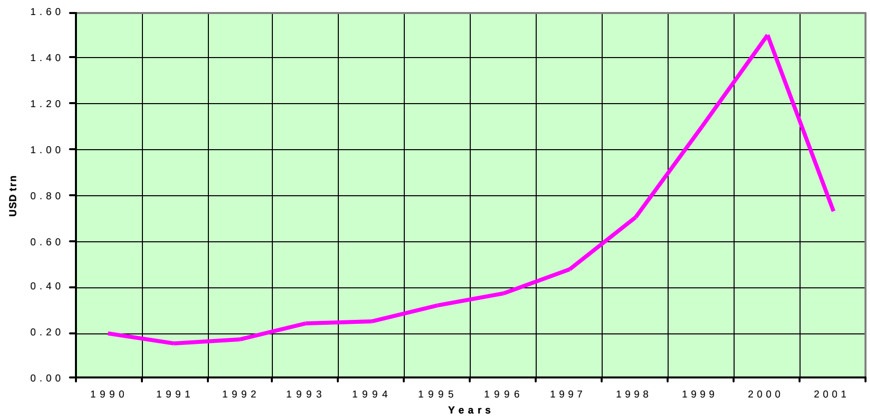

FIG. 1: WORLD FDI INFLOWS, USD TRN

The countries of Central-Eastern Europe, particularly those close to the EU border, remain an island of a relatively positive potential development. We can see it from the data in Figure 1, showing the flow of direct foreign investments [FDI][3], between 1990 and 2001 in the world as a whole. It is easy to observe the constant growth until the peak of 2000 and the subsequent crash in 2001. This was probably influenced by the September 11th attacks, or by the more general recession, hitting the world economy after the explosion of the technological bubble and the corporate scandals in the USA.

Economists state that in times of crisis economic fundaments emerge: companies or countries which are able to oppose resistance to the crisis strengthen their economic “immunity system”.

An analysis of the negative peak of 2001 per geographic area results in data shown in Table 1.

TAB. 1: FDI IN THE VARIOUS WORLD AREAS IN 2001[4]

Geographic areas	Funds USD billions	Change % 2000/2001
EU	320	-60
North America	150	-59
Asia	100	-24
Latin America	80	-11
CEE	25	+2
Africa	20	+97
World	695	-54

The only areas of growth in FDI in this two-year period have been those of Africa and of Central-Eastern Europe. In the African case there have been few big projects[5], which have almost doubled the FDI from one year to the other, whereas in the CEE area, a large number of small investments came into the area, marking it an almost unique example which was able to escape the 2001 world recession[6].

Conventional wisdom holds that FDI will be an important force for change, reconstruction and growth in the Central and Eastern European countries[7]. The authors of one report also argue that economic growth and FDI inflows are closely related in CEE economies. They argue accelerated economic growth and economic growth leads to more FDI, in a various circle[8].

The countries of Central-Eastern Europe therefore, must dispose of something basic which is pushing forward the number of investments. In order to understand better what it could be, we will quote some considerations, taken from the autobiography of the corporate CEO, Ferdinand Piëch, the man who saved Volkswagen from the destiny now threatening Italian Fiat[9] and others[10]. In the past, the German company has purchased various foreign brands, aiming at the market expansion strategy. Among them we can list Skoda, in the Czech Republic, a factory in Bratislava, Slovakia, built during the old regime, but until then unutilised, SEAT, Spain, a factory in Mexico and others. Piëch states that whereas in Germany the manpower had a share of 26 – 27 % on the final cost of the product, in the Czech Republic the same data added to less than 3%. The advantage "had to be transformed in a price advantage, aiming at building a strong and healthy market position". From the same text[11], another interesting statement is the following one, related to a comparison between two Volkswagen locations, Mexico and Slovakia: "Mexico turned in the meanwhile in one of the most expensive locations. The share of the manpower cost on the final product is much higher than in Bratislava". Moreover, Piëch evidences another important aspect: the personnel employed in Bratislava for assembly work was highly technically educated, instead of uneducated manpower, as in some other parts of the world. Actually, this fact has a strong influence on the quality of the operations carried out.

This last statement throws an even clearer light on the data of Table 1: the countries of Central-Eastern Europe represent an area of low-cost, and in the same time, of high quality labour[12].

These are the facts which support notion that in the future Companies also for the future a powerful push will move toward locations of international operations in the countries of Central-Eastern Europe. This will assume a growing role for the development of investments, either productive, or of other kind. As a matter of fact, the economic development will improve quality of life of those populations, raise income total, demand and markets.

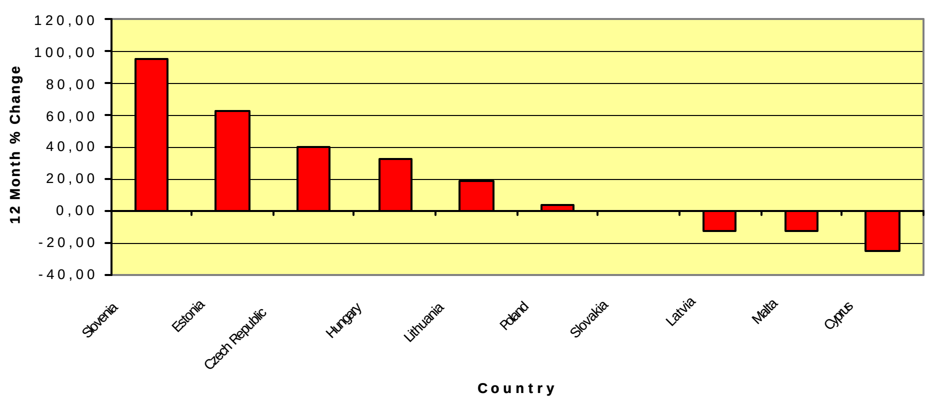

FIG. 2: EMERGING EUROPE: 12-MONTH STOCK MARKET RETURNSOURCE: IHT, OCTOBER 29, 2002, HSBC, BLOOMBERG.

The above considerations are strengthened also by Figure 2, showing the results obtained by portfolio investments in the stock exchanges of the countries new entrants in the EU in 2002, most of them from the Central-Eastern European region. Remarkable to that regard are the results obtained by the investors especially in Slovenia, Estonia, Czech Republic and Hungary.

FDI inflows to CEE countries [CEECs] soared to record levels. In 1995, the region accounted for 5% of world inflows, compared with only 1% in 1991. CEECs' share of total FDI inflows accounted for 3%-4% between 1995-1998[13]. This growth was driven not only by waves of privatisation, but also by economic recovery in some countries, especially in CEFTA. According to some estimates, CEE as a region has the potential to attract 10% of world FDI inflows; however, currently FDI inflows to CEECs remain low when compared to the world as a whole.

But we must not think that in the countries of Central-Eastern Europe this is overwhelming. In fact, the FDI rate, even though positive, as we can see from Table 1, represents only the 3.59 % of the world total in 2001.

The strongest proponents of FDI's role in CEECs [see Dunning 1993, p. 20] argue that multinational enterprises supply many of the necessary ingredients for economic growth, the reshaping of attitudes toward work and wealth creation, the redesigning of the business and legal framework, etc. [Paliwoda, 1997, p. 27]. In addition, the Central and Eastern European nations are seeking to regenerate their economies quickly, a task in which FDI plays a pivotal role. There are many articles written about the role of FDI in transitional economies. While it may be accurate to assert that the highest level of restructuring are to be found in enterprises that have FDI, the precise nature of restructuring and change in these companies at the firm level, as well as their impact an other local companies and their functional environment, have not yet been described and analysed in any systematic fashion. Case studies of enterprises with FDI are common: these usually describe the changes, conflicts and results after the entry of a foreign investor into a previously state-owned company [see for example Fogel, 1995; Nilsson, 1996].

Some authors point out that foreign investors should be more aware of the unique conditions in CEECs, particularly of the obstacles to organizations change which include such internal factors as unfavourable employee or managerial attitudes and incompetence, and external parries the legal environment and structures for corporate governance [Petrice, 1995]. On the other hand, several authors, especially from CEECs, have a different perspective: they try to evaluate the positive and negative impact of FDI on indigenous companies, and they do not pay attention to local obstacles [Blazova and Valent, 1995; Outrata et al. 1996; Bajzikova and Svobodova, 1998]. The obstacles, which seem to influence most the expansion of the FDI in Central-Eastern Europe are two:

1. The inheritance of the old regimes, with their hurdles to the free development of entrepreneurship,
2. The cultural differences between East and West.

The first problem was very much present at the beginning of the process of economic transition from plan to market economy. We can see it from Fig.3, showing the per capita GDP pattern in the countries of Central-Eastern Europe after transition.

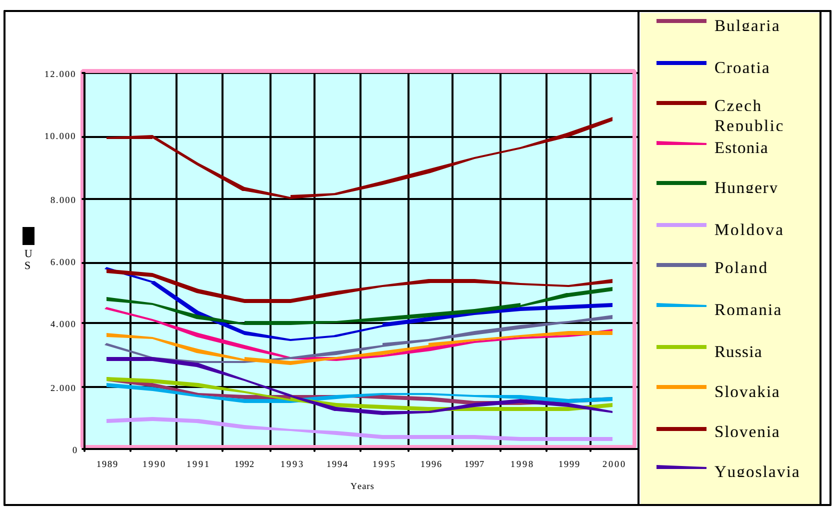

FIG. 3: PER CAPITA GDP IN THE TRANSITION PERIOD

While some of those economies started to grow after the initial slump, showing their detachment from the old ways, others are still in a stalling position.

The standard of political stability and economic performance are considered to be the most important incentives for foreign investors, especially when large investment projects are involved that require a politically reliable and economically effective environment over the long run. Surveys among western investors have shown that political and financial certainty in making decisions on investments in CEECs is the most important factor.

It seems the problem of the cultural difference is the cause. Therefore, it is difficult that it could be easily removed in the short period. As a consequence, investors directed toward those countries will have to consider this aspect as a constant environmental characteristic, to be confronted with opportune adaptation strategies.

Because of confidentiality of our sources, we can illustrate the real situation by the following example. An important Italian holding inherited, from a failed Austrian partner, a factory in a country of Central-Eastern Europe. The plant was in a pretty good shape, employing a workforce of 250. In order to manage the situation, the new owners decided to send to the spot an Italian "pro-consul" with directing powers. The Director was not able to communicate his intentions to the personnel, entering into conflict with his immediate subordinates. The local employees appeared to him as an aboulic mass with low interest for business benchmarking, even though their existence depended on it. Eventually the management results were so bad that the ownership decided to shut down the "venture". Before this last step, the owners were convinced for a last trial, introducing a new person in the company, also of Italian origin, but with a decade of experience in international business. This person was to act as a "cultural bridge" between the Italian ownership, the local management and labour. The result was immediately remarkable: after a short time the factory was on track again, exhibiting a good productivity and quality. Moreover, the company grew, reaching an employment level of almost 1,500. The factory is nowadays the "hard core" of the whole industrial group. Its products are sold on world markets with western brand and "griffe", but in the back of it, and as a guarantee, there is the solid productive position in Central-Eastern Europe.

What measures did the new manager utilize in order to get such results? After analysing the facts, it is possible to find out that he used a whole series of measures, [the details of which we cannot describe here] because of confidentiality. They consisted mainly in representing the reasons of the various groups, bridging the needs and the cultural points of view of owners and labour in order of reaching corporate goals.

The person is certainly exceptional, as it is shown by data and results. In a certain sense, it is possible to state, that his defect is his uniqueness. It is not possible to think that all the companies which will want or must transfer their activities in the countries of Central-Eastern Europe will be able to use "bridge" persons of the same kind. Hence, there is a need that the techniques used by the manager of this and similar case studies, are made available to all managers who would need them in order to manage with success the cultural diversity problem in mixed managerial groups.

If we turn to a more general point of view, we can state that the diversity of values, attitudes and approaches between expatriates, who cover higher organizational ranks in the international company and locals, represents a concrete menace for the development of the corporation, and may indeed provoke situations of internal conflict, leading to negative results and sometimes failures to international operation.

There could be two kinds of problems: an endogenous problem, i.e., a problem of managing the intercultural diversity within the company, and an exogenous one, regarding the relationship between the company management and the local environment. With the SWOT[14] method, an inventive management is sometimes able to transform the environmental threats in opportunities for the company.

The task of this research consists in investigating, if the effort of knowing and challenging this kind of conflict can be, in first place managed and in second place, exploited, to the scope of creating a competitive advantage for companies with foreign investments in the countries of Central-Eastern Europe.

The bibliographic research, in the initial stage of the project, has shown that the largest part of the available literature[15] in the area of the management of cultural diversities is of USA origin[16]. As the environmental variables in the USA and in Europe bear different characteristics, the models present in the existing bibliography must be adapted to the European reality, in this case to the one existing in Central-Eastern Europe[17].

The field research, which was carried out afterwards[18], has had an exploratory character until now. For example, the first stage was oriented to detect and describe specific characteristics of the phenomenon, which we have defined as impact of cultural differences on the business performance in the countries of Central-Eastern Europe.

The main research hypotheses are the following ones:

Hypothesis 1

The performance of the international companies employing local workforce depends on cultural diversity. Managing culturally diverse workforce represents a threat for the success of the operations. This threat can be transformed into competitive advantage for the company, if *management of the cultural diversity* is developed as a part of strategic management of the company.

Hypothesis 1.1

Management of foreign companies in countries of Central-Eastern Europe does recognize the problem of cultural diversity in the international business.

Hypothesis 1.2

Management of foreign companies in countries of Central-Eastern Europe is able to manage the problem of cultural diversity in the international business.

Hypothesis 1.3

Management of foreign companies in countries of Central-Eastern Europe is able to create a specific competitive advantage, starting from the cultural diversity in the international business.

Hypothesis 2

The role of company leaders is crucial for the success of the international operations assigned to them. Between the different leading capacities the manager of international operations must accept two characteristics important to this research: recognition of cultural differences and competence in treating them.

For the purpose of gathering data on the subject, we decided to use as research instrument the survey method based on two types of questionnaires, the first one oriented on general directors of companies, the second one dedicated to local managers positioned at lower managerial ranks.

The final version of the questionnaire for general directors is organized around the following points:

TAB. 2: STRUCTURE OF THE QUESTIONNAIRE FOR GENERAL MANAGERS

I Manager data: General data Data on foreign managers Data on local managers
II Company data General data Data on the relationship company – environment
III Data on the management of human resources General policy on HR Data on management of cultural differences
IV Direct questions

In the first stage of the field research we lead face-to-face interviews with general directors.The first period the surveys were carried out was during the period of June-July and October 2002 in Slovenia, a country chosen for evident reasons of geographic proximity. But the research is being extended; we are trying to include other countries of Central-Eastern Europe. The second period of research was realized in Slovakia during November 2002-January 2003.

The questionnaire for local managers consists of 15 closed questions. The first part was dedicated to the career background and the schooling level of the managers, whereas the second one was centred on management of cultural diversities. In each company we made available also three questionnaires for local managers. The local managers, who are positioned on lower levels of the managerial structure, have been asked to return the questionnaires after answering the formulated questions. To obtain comparisons about the management of cultural differences, the scope included both the general directors as well as other local lower-ranking managers.

The result of the analysis of the data gathered represents the base for a subsequent expansion of the research problem.

The obtained record of cases is very diverse, and tends to scatter in a series of individual “stories” with spotted characteristics. But applying a generalization trial, it seems possible to evidence, within the various “cases”, some common features: there are three groups of factors influencing the management of cultural diversities in international companies:

1. The origin of the mother company [country of origin of the equity];
2. The personal sensibility of the top management regarding cultural diversity;
3. Sector of activity.

As far as the first point is concerned it looks like if cultural differences between locals [Slovenes, Slovaks] and Germans [Austrians] are smaller than those observed between locals and citizens of the Mediterranean countries. It seems easier to overcome the communication and trust barriers between German or Austrian investors and local workforce [Slovene]. For instance, German and Austrian investors try to introduce “a common organizational spirit”, with the aim of improving the loyalty of workers toward the company. Among the non-financial motivational instruments commonly used in international operations, they use socialization methods, such as outdoor socialising, Christmas and Easter gatherings with the members of the worker families, and so on.

It is possible to state that the South European investors [particularly Italians and French] adopt a more ethnocentric approach of management to their investments in countries of Central-Eastern Europe [Slovenia, Slovakia], whereas those of Western Europe, in particular Germans and Austrians, implement more frequently a polycentric and in some cases, even geocentric approach in the management of their international activities.

This fact is illustrated by the data indicating the assignment of key positions of the international operations: 80% of the key positions of the companies which are connected with Latin countries are covered by employees of the mother company, whereas the companies originating in Western Europe trust them by only 11%.

Our result regarding the cultural characteristics of the workforce taken into consideration can be synthetically expressed as in Table 3:

TAB. 3: CULTURAL CHARACTERISTICS OF THE SLOVENE WORKFORCE

Favourable characteristics of the Slovene workforce	**Unfavourable characteristics of the Slovene workforce**
Disposition to learn	Low risk propensity
Good executors	Low responsibility propensity
Easy integration in diverse work environments	Low bargaining propensity
Good technical and linguistic capacities	Scarce managerial capabilities

TAB. 4: CULTURAL CHARACTERISTIC OF THE SLOVAK WORKFORCE

Favourable characteristics of the Slovak workforce	**Unfavourable characteristics of the Slovak workforce**
Disposition to learn	Middle risk
Good executors	High responsibility
Good technical skills	Moderate bargaining
Good languages skills	Moderate managerial capabilities

If we analyse the Slovene cultural identity applying the five cultural dimensions proposed by Hofstede,

and compare them to the results which he obtained for Mediterranean and Austro/German nations, the outcome is
the one illustrated in Table 5.

TAB.5: HOFSTEDE CULTURAL DIMENSIONS APPLIED TO THE THREE NATIONS

Dimensions of the national culture	SLO	LAT	AU – GER	SK
Power distance	High	Middle	Low	High/Middle
Individualism	Low	High	Middle	Middle
Masculinity	Low	Middle	High	Low
Propensity for uncertainty	Low	Low	Middle	Middle
Orientation to the long term	Middle	Low	Middle	Middle

Regarding the second research hypothesis, it seems that research confirms it fairly. Top management is seen as a bridge between two realties, e.g. the mother and the local company. By carrying out the delicate role of bridging the barriers caused by cultural diversity, three types of managers are devised:

?? Bi-cultural managers;
?? Managers with significant foreign experience;
?? Managers with little or no experience in international environment.

The managers, who by birth belong to two cultures, are the most sensible to the problem of cultural diversity. Many were born and grew up in border regions between the two countries, and have close relatives or even parents originating from the culture of the other country, Slovenia. They have experienced the influence of two cultures from birth, or from their youngest age. As a consequence, for them the presence of the two cultures is a daily occurrence. They possess a natural sensibility for the problem of cultural diversity, which they transmit daily to the working environment. In other words, their long experience with the two cultures helps them to have a more natural and more effective approach toward this kind of problematic.

The managers, who are part of the second group, either have a significant background in the international activity, or simply, are living abroad. This means that the majority of them, in some way, have experienced the impact of cultural diversity. Therefore, they put in the field a significant effort in order to understand the culture they were introduced to by the foreign task. The effort is not based on specific techniques developed in order to manage the diversity, but on intuition.

The third group of managers is employed in the international operations for the first time. This means that when they are for the first time living abroad, they do not attempt to understand different living and working conditions. This is closely related to the cultural shock experienced at the moment they enter the foreign country, Slovenia, or Slovakia either alone, or with families. Similar is the situations for managers who are daily commuting between the mother and the work country [Slovenia]. It is a not so rare situation in the examined case, due to the dimension and geographic position of Slovenia.

A third factor determining the degree of attention given to the cultural diversity is bound to the business sector where the company is operating. For instance, the situation is very different in manufacture or in retail sector. In the first case the only objective of the company is managing workforce in order to improve productivity. In this case the management of cultural diversity has a role, which is limited to the task of improving productive efficiency of employees. In the second case there is also the problem of product assortment and of connected services that are to be managed in order to satisfy local consumers. In this case there is a double pressure on management of cultural diversity, asking for a more sophisticated effort. The transfered company's culture, management, and incentive structure has been more problematic than the transfer of technology [cases of Slovakia]. A refusal to agree with management systems, culture and conditions, together with others factors caused a dramatic employment decline [more than twice]. After four years, productivity increased dramatically [from 130 units of output per employee in 1992 to 660 units in 1998, and to 1500 in 2000]. Great emphasis is placed on the system of profit sharing [wages depend on company profit] and system of worker recognition based on individual productivity, flexibility, etc. One reason for the productivity increase results from precisely these factors.

At the end we can formulate the following considerations of general character:

The cultural diversity is an important characteristic of FDI in countries of Central-Eastern Europe [Slovenia, Slovakia]. Many managers do not recognize it, or consider only its negative impact. Some managers try to manage it, only to prevent possible conflicts. Only in few cases the managers try to obtain a competitive advantage from this situation. Management of cultural diversity asks for a remarkable effort, especially by the top management. The results can be expected only in the medium or long term. Therefore, management of cultural diversity should be an integral part of strategic business planning of the company. There is a remarkable need for formulation of concrete management techniques in order to manage cultural diversity.

Taking into account the above considerations, a model can be designed for creating competitive advantage in international companies in countries of Central-Eastern Europe. It is based on the following preliminary considerations: a managerial team in order to run well must eliminate stress and if possible, also create job satisfaction among actors. This goal can be reached only if each person does the role for which he or she is most talented and specialized. Taking into account the data in Tables 3,4, and 5 it would appear that competitive advantage could be reached initially by mixed managerial teams in CEE countries, formed by expatriates and locals, [if expatriates take the burden of the basic decisions and bargaining], and locals who execute the bulk of the routine activity. With time these roles could change. This research has arrived at certain conclusions, which can also serve as a background for the future research investigation.

References

Contact the author for a list of references.

End Notes

1 Acronym: CEE

2 The clash of civilizations, or to say it better, the adaptation of local civilizations to the civilization of the so called "modernity" is today a problem of great political and economic interest.

3 The Economist, September 21-27, 2002.

4 Cfr.: The Economist, UNCTAD.

5 Repeating the Economist's statements.

6 Indeed if in Africa the increment has been 97%, it means that we jumped from 10 to 20 billion USD in only one year, whereas in the CEE there has been an increment from 24, 5 to 25 billion dollars in the same period. A much more regular pattern.

7 UNCTAD, 1995, p. 104.

8 UNCTAD, 1996, p. 66-67.

9 See: Ferdinand Piech, AUTO. Biographie, Ed.: Hamburg, Hoffman und Campe, 2002.

10 Big problems are shown also by other car giants.

11 Op. q. p. 215.

12 Also Piech states it.

13 UNCTAD, 1999, p. 20.

14 SWOT, acronym of Strengths, Weaknesses, Opportunities and Threats,, see, for instance.: Kotler Philip (1997) Marketing Management, Analysis, Planning, Implementation and Control, Prentice Hall NJ, p. 84.

15 Hofstede, Greet (1980) Culture consequences: International Differences in Work-Related Values, Beverly Hills CA: Saga Publications

16 Laurent, André (1983) The Cultural Diversity of Western Conceptions of Management, International Studies of Management and Organization, Vol. 13, no.1-2, pp. 75-96

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Virtual Teams: A Matter of Performance and Effectiveness

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Abstract

Change is not only inevitable, but has vastly accelerated in pace and complexity; changes in communication technologies have facilitated information transmission around the world and it now enables geographically dispersed groups of people to work together on projects. These are virtual teams that communicate via telephone, fax, interactive televised conferences, and computer mediated devices. Computer mediated communication (CMC) is the most commonly studied form of virtual groups (Gonzalez and Burke, 2000). In these types of groups, participants interact using CMC devices such as e-mail, voice mail, and videoconferencing. Thus, recognizing that a new form of group work has evolved, this paper intends to review the research that has been done to explore the factors that lead to, as well as those which limit, the success of a virtual team. Specifically; this review will address cohesiveness, heterogeneity, and motivation as issues that affect the performance and effectiveness of virtual groups.

The Applications of the Concepts of Work Group, Team, Group Performance and Group Effectiveness in Virtual Groups

The Difference between Work Group and Team

Guzzo and Dickson (1996) state that a "work group is made up of individuals who see themselves and who are seen by others as a social entity, are interdependent because of the tasks they perform as members of a group, are embedded in one or more social systems (e.g. community, organization), and perform tasks that affect others (such as customers or coworkers)". Forsyth (1999) asserts that "teams" are specialized types of work groups; these groups stress cooperation among members, higher levels of structure and coordination, cohesion, and goal attainment. Guzzo and Dickson (1996) suggest that groups become "teams" when they develop a sense of shared commitment and strive for synergy among members.

The words "team" and "group" will be used interchangeably in this review; recognizing, that there may be degrees of difference, rather than fundamental divergences, in the meanings implied by these terms. For the purpose of this paper the definition of a "virtual team" will include distance groups that collaborate on projects by communicating mainly through computer mediated devices.

The Difference between Group Performance and Group Effectiveness

There has been confusion in the literature regarding the definition of effectiveness. In a general sense, effectiveness is conceptualized as the effect of performance (Gonzalez and Burke, 2000). Commonly, group effectiveness is measured in terms of outcomes that are aggregated from the individual to the group level. Sundstrom et al. (1990) cited from Gonzalez and Burke (2000) state that effectiveness in groups is indicated by a) group-produced outputs (quantity, quality or speed), b) the consequences a group has for its members, or c) the enhancement of a team's capability to perform effectively in the future. Given the variety of indicators of effectiveness, the relevant issue is to select a perspective of effectiveness and its causes that is fundamental, basic, and central to a variety of approaches. The effectiveness of virtual groups has been typically measured with respect to the quantity of ideas produced by participants in brainstorming tasks, the time spent in accomplishing the task, or an assessment of the quality of ideas (Sproull and Kiesler, 1991). Other outcomes that have been examined are the extent to which the groups can accomplished complex tasks or whether not consensus can be reached (Buzaglo and Wheelan 1999; Campion and Medsker 1996).

Maznevski and Chudoba (2000) state that "understanding virtual team effectiveness requires a complete description of process and structure, of technology and social systems, and of the interaction among these dimensions over time" (p. 489). For the purpose of this paper, effectiveness will be defined as the quality of a specified output that results from the group's performance.

Are Face to Face Groups More Effective than Virtual Groups?

Whether virtual groups or face to face groups are superior in task performance appears to depend on the task. Guzzo and Dickson (1996) state that computer mediated groups appear superior at generating ideas but face to face groups appear superior on problem-solving tasks and tasks requiring the resolution of conflicts. However, these authors also recognize that a large part of the effect of computer technology in groups may be due to the structure of the task imposed by the use of computer technology, rather than other aspects of the electronic medium. The increased structure of the task--whether by computers, or by no technological means--seems to enhance group processes. Although task type is often proposed to moderate the relationship between a medium and its effect on performance there does not seem to be a consistent pattern of task types for which communications technology is better or worse. Maznevski & Chudoba (2000) propose that a combination of media including face-to-face outperforms one without face-to-face.

Guzzo and Dickinson (1996) state that the continuing spread of computerization has been accompanied by an expansion of research on groups that use computers in their work. They state that this research has in large part focused on comparing computer mediated group meetings with non-computer mediated meetings and, where work is done by groups, on idea generation and choice making. Research should not focus anymore on comparing face-to face groups to virtual groups; that could have been an important issue ten years ago. But now the main focus should be in trying to understand the interaction between process, structure, technology and performance in specific group environments.

Factors that Influence Task Performance and Effectiveness in Virtual Groups

Cohesiveness

Cohesion is the strength of the bonds linking individual members to one another and to their group as a whole and that makes them commit to the group (Forsyth, 1999). According to Zaccaro (1991), cohesion is a multidimensional variable that consists of different factors, binding social forces, a sense of unity, attractions to individuals members and the group itself, and the group's ability to work as a team are all components of cohesiveness (Foresyth, 1999).

A Review of cohesiveness research (Guzzo and Shea , 1992) revealed a positive association between cohesion and performance. As cohesion increases, the internal dynamics of the group intensify; and this may provoke that people are more ready to accept the group's goals, decisions, and norms. One noteworthy aspect is that even though cohesive groups usually outperform less cohesive groups, this relationship between cohesion and performance is strongest when members are committed to the group's tasks. Indeed, if a group’s norms do not encourage high productivity, cohesiveness and effectiveness are not positively related (Forsyth, 1999). Also, this author states that performance causes changes in cohesiveness; groups that succeed tend to become more cohesive, and groups that fail tend to become less cohesive. In summary, cohesion may not be a sufficient condition for effective groups, but it is a necessary one. Without cohesion, feedback would not be accepted, norms would never develop, and groups could not retain their members.

Cohesiveness in the Context of Virtual Groups

The literature reviewed suggests that special attention should be paid to the components of group cohesion for achieving effectiveness in a virtual team. As suggested by Guzzo & Shea (1992), creating interventions that promote interpersonal attraction and task cohesion can lead to improvements in collective efficacy, and subsequently to enhanced performance and effectiveness of virtual groups. The interventions could take the form of a) training programs, especially in the use of computers and distance collaboration technology; so the participants can become familiarized with the communication mean, and therefore be attracted to the task, b) meeting face-to-face in the early existence of the group, so that a shared view of the task may be developed (Maznevski and Chudoba, 2000), and c) interactive meetings throughout the project via videoconferencing (a substitute for the face to face interaction) that may help accelerate the socialization process and build group cohesion (Gonzalez and Burke, 2000). Cohesion builds more slowly in virtual groups than in a face-to face group, so the interventions (actions) proposed in this section might prove useful for achieving cohesion and thus also effectiveness in virtual groups.

Group Heterogeneity

Guzzo and Dickson (1996) define heterogeneity in a group as the mix of personalities, gender, attitudes, and background or experience factors. The extent to which team effectiveness is affected by the heterogeneity among members is a complicated matter. Jackson et al. (1995) cited from Guzzo and Dickson (1996) reviewed and summarized empirical evidence from a number of related disciplines about the link between diversity (that is, within group heterogeneity) and team effectiveness. Their findings reveal that heterogeneity is positively related to the creativity and the decision-making effectiveness of teams; specifically when generating alternative solutions to a problem and applying a range of perspectives in analyzing business problems. Although evidence supporting the value of member heterogeneity for team performance is clearest in the domains of creative and intellective tasks. In addition to the above evidence, Jehn, Northcraft and Neale (1999) suggest that for a team to be effective, members should have high information diversity, which refers to differences in knowledge bases and perspectives that members bring to the group, and low value diversity, which occurs when members of a workgroup differ in terms of what they think the group's real task, goal, target, or mission should be. These authors also state that value diversity becomes more important as a predictor of group performance over time, while age and gender diversity become less relevant over time. Thus, it seems that certain types of similarities are more important than others. Specifically, the diversity associated with values, and not social category, is the one that causes the biggest problems and has the greatest potential for enhancing both workgroup performance and morale.

The composition of a group can affect its structure, dynamics, or performance in a variety of ways. Jehn, Northcraft and Neale (1999) state that a review of forty years of diversity research concluded that there are no consistent main effects of diversity on organizational performance. Researchers have studied these effects, but only few have conceptualized group composition broadly. Moreland and Levine (1992) recognize that there has been little theoretical integration of work involving different characteristics. These authors propose to develop a model of those effects that both describe and explain the causal role of group composition in various aspects of group life. One possible way could be to include different contextual aspects (task and organizational characteristics) and different types of diversity (psychographic and demographic). In the following section, heterogeneity in the context of virtual groups will be discussed.

Heterogeneity in the Context of Virtual Groups

According to the literature reviewed, the "natural" diversity present in virtual groups may represent an opportunity to share different information and to apply a wide range of perspectives when analyzing a specific problem. Maznevski and Chudoba (2000) state that "[heterogeneous] groups offer high potential for performance on complex tasks but often fail to realize that potential" (p.476). These authors state that a virtual team's composition may be an influential structural characteristic, and integration processes are likely keys to performance. The integration process includes relationship building to develop a shared view of the task and strong, trusting relationships among each member of the group.

Kahai and Cooper (1999) suggest that to develop a shared view of the task, management interventions, as well as computer-mediated communication systems can be designed to increase task-oriented communication and reduce negative socioemotional communication. Those managerial interventions could include the establishment of ground rules that inhibit negative socioemotional communication while promoting task-oriented communication.

On the other hand, "virtual team trust" is essential for a group of diverse individuals to develop into a fully functioning team. According to Mayer, Davis and Schooman´s (1995) cited from Javernpaa, Knoll and Leidner (1998, p. 26), "trust is the willingness of a party to be vulnerable to the actions of another party based on the expectation that the other will perform a particular action important to the trustor, irrespective of the ability to monitor or control that other party, " For practicing virtual teams, an interesting finding suggests that high-trust teams exhibit "swift trust", which is defined as a form of depersonalized action, with less emphasis on feeling, commitment, and exchange; and more emphasis on action and the task (Javernpaa, Knoll and Leidner, 1998 p. 21). "Swift trust" enables members to take action, and this action will help the team maintain trust and deal with uncertainty, ambiguity, and vulnerability while working on complex interdependent tasks with strangers in a situation of high time pressure.

For practicing virtual teams the literature reviewed suggests a number of strategies that might work to enforce trust. These strategies include: a) rotating leadership (allowing for members to be leaders in their particular area of skill may reduce the dependency on any particular person); b) task goal clarity, role division, and specificity (discussing the goals of the assignments to a great extent may give the team a sense of reduced vulnerability); and c) frequent interaction with detailed responses to prior messages (to reduce ambiguity and uncertainty) (Javernpaa, Knoll and Leidner, 1998) Research on trust in virtual teams is a wide open field and future research may focus in verifying current findings and more rigorously understanding the means to attain and maintain it.

Motivation

Motivation is a relevant factor that affects the effectiveness in team jobs, just like it does in individual jobs. In a general way, motivation is shown by a persistent dedication of effort, energy, and commitment to a group task, it is a vital ingredient that can transform a collection of individuals into a true working unit (Boiney, 1998). The particular issues related to group motivation that will be addressed in this section are: expectancies, goals, interdependency and group potency. Classic expectancy-value theories of motivation suggest that two factors determine group members´ level of motivation: their expectations about reaching a goal and the value of the goal (Forsyth, 1999 ; Crisson, Seta and Seta, 1995). Motivation is greatest when people think that the goal is within their reach (expectations are high) and they consider the goal to be valuable. Motivation diminishes if expectations are low or individuals do not value the goal.

In general, according to Forsyth (1999), group members work harder when: a) they are personally interested in the group´s tasks; b) they feel that their contributions to the group are indispensable; c) they feel others will not free ride; d) when they feel the group's goals are clear and challenging, and; e) they are confident in their group's ability to reach its goals (collective efficacy).

Another noteworthy theme related to motivation is interdependence, which comes from the work of Guzzo and Shea (1992); in which they emphasize that interdependency is the defining characteristic of teams, and is related to effectiveness because interdependent tasks may be completed more efficiently in the context of a group. Interdependency may work also to increase motivation by enhancing the sense of shared responsibility for, and reward value of, group accomplishment.

Finally, another issue related to motivation is "group potency", which was introduced by Guzzo and Shea (1992). These authors define group potency as the group's collective belief that it can be effective. They differentiated the construct from other related constructs (e.g. collective efficacy) and reviewed evidence that the strength of this motivational belief significantly predicted group effectiveness in customer service and other domains. Group potency is considered to be task general and not as task specific as collective efficacy. That is, group potency has been used to assess groups with long-term interactions that engage in several tasks or activities (Gonzalez and Burke, 2000). Motivation in the context of virtual groups will be discussed in the following section.

Motivation in the Context of Virtual Groups

The perceived complexity of operating through Computer Mediated Communication (CMC) itself may affect motivation in distance collaboration groups. More specifically, the literature reviewed (Kahai and Cooper, 1999: Guzzo and Dickson, 1996; Guzzo and Shea, 1992) states that accomplishing tasks through distance collaboration groups takes longer than in face to face situations since decisions tend to be more polarized and people may face problems reaching consensus. Thus, the organizational challenge is first to effectively create the virtual teams and, second, to overcome the inherent resistance that inevitably accompanies large-scale innovation.

Importantly, providing adequate training (in terms of both technical and team skills), and adequate managerial support (in terms of resources, information, and encouragement) may motivate participants to become familiarized with the communication means and therefore to be more attracted to the task. Research has shown that on line communication must be much more explicit than verbal interactions, and that geographical separation amplifies the need for explicitness (Nunamaker, Briggs, Mittleman, Vogel, and Balthazard 1997). Another aspect that can affect motivation in a virtual group is that electronic communication can provide group members with too much stimulation, with the result that a flood of information to process overwhelms group members.

The use of internet or other means of distance interaction may constitute in itself a difficult task to perform: so, by feeling comfortable with the means of interaction, team members may be more attracted to the task and also confident of their ability to work in this setting, which in turn may contribute to increased motivation and commitment. Additionally, Crisson, Seta and Seta (1995) propose that linking rewards to the accomplishment of such tasks would increment the "perceived value" of the work and possibly would motivate people in the group to expend more effort and to be more committed. Future research could focus on analyzing the effectiveness of different types of rewards for different types of tasks and groups.

Especially interesting in this review was the empirical evidence found by Early (1994) cited from Guzzo and Dickens (1996) about the role of individualism-collectivism (a culture based individual difference) in shaping the impact of motivational training for individuals. Group-focused training was found to have a stronger impact on collectivistic individuals, and self-focused training was found to have a greater impact on individualists. An important issue to consider in the case of Mexico (collectivistic culture).

Conclusions and Options for Future Research

Virtual groups, as a new creative method of collaboration, offers several challenges for their effective implementations in organizations: first, they require an understanding of group process variables that affect the performance of these new forms of workgroups, so that effective actions can be taken; and second, an understanding of how to overcome the inherent resistance that inevitably accompanies large scale innovation. Gu zzo and Dickson (1996) recognize that although the first studies of electronically mediated teams were done more than twenty years ago, the pace of research on such teams has accelerated in recent years. These authors suggest that research on virtual groups should apart from the tradition of comparing those groups to face-to-face groups. Future research should accept such groups in their own terms and focus instead on contrasting technologies and on team effectiveness under different ways of utilizing available technology. Guzzo and Dickson (1996) state that "from a practical point of view we need more research on how to maximize team effectiveness with new technologies; and from a theoretical point of view we need better insights and explanations of the drivers of the dynamics of team performance and effectiveness under such technologies" (p.333). In addition, Maznevski and Chudoba (2000) recognize that empirical research on virtual teams is limited to a few studies on specific elements of virtual team process and state that "the simple conclusions from single studies do not provide a well-integrated understanding of virtual team process and performance" (p. 476). As stated previously in this review, research on virtual teams is a wide open field and future research may focus in verifying current findings and more rigorously pretend to understand the factors that lead to, as well as those which limit their effectiveness.

This paper reviewed cohesiveness, heterogeneity and motivation as critical issues that affect the performance and effectiveness of virtual groups; proposing actions (interventions) aimed at improving team effectiveness. Guzzo and Dickson (1996) in their review of team's performance and effectiveness concluded that three critical points exist for intervening to enhance team effectiveness. One is the "design" of the group that includes such things as specification of membership, of member roles and methods of their coordination, and of goals (e.g. group composition). The second is the "process" element that includes both social process in groups (e.g. cohesiveness) and task processes (e.g. rules of task performance); and the third point is the "context," which means team performance can be raised by changing the conditions in which team perform (e.g. leadership and motivation). Guzzo and Dickson (1996) conclude that the element with the most consistent research support for affecting team performance is the "context". In fact, these authors conclude that the greatest changes in team effectiveness are most likely to be realized when changes in teams organizational context are supported by the appropriate team design and process. Maznevski and Chudoba (2000) state that "understanding virtual team effectiveness requires a complete description of process and structure, of technology and social systems, and of the interaction among these dimensions over time" (p.489).

Mainly, the suggested topics for future research in this area are related to the issue that the literature reviewed tends to present a lack of consideration of the "context" in which the virtual group operates (e.g. culture, environment, organization, and task). Thus, future research could be aimed at studying in different contexts how the issues analyzed in this paper could vary in their importance and relationship to group performance and group effectiveness. Especially interesting would be to study those issues in a collectivistic culture like Mexico. Other specific questions for future research might be related to the topic of task cohesion, which according to the literature reviewed, appears to be importantly related to virtual team effectiveness. The proposed research questions in this area are: a) who types of training programs work better to build task cohesion? b) Which factors lead to develop task cohesion? And, c) Does meeting face-to face in the early existence of the group and having interactive meetings throughout the project via video-conferencing really help to develop task cohesion? Finally, it would be interesting to explore the following issues related to heterogeneity and motivation in virtual groups: a) How does the "natural" diversity present among members in virtual groups can be effectively managed?; b) How can trust be assessed and maintained in virtual groups ? And, c) Which types of motivational rewards work best to enhance performance in virtual groups?

Technology-based group communication will continue to thrive and researchers will have to make an effort to keep up with the pace of these changes. Research will be needed on how to maximize team effectiveness with these new technologies. An important issue to be considered is that, regardless of the enthusiasm or skepticism that virtual groups have provoked; organizations require to challenge the traditional assumptions about the way they operate, and need to gain a more profound understanding of the human side of this technological revolution.

> "…Though there is a revolution afoot, there is still more much to Learn…it is too early to tell who will succeed and who will fail in the Long run…"
> (Kanter, 2000)

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Competitive Excellence in the Supply Chain

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Abstract

Competitive pressure forces companies to exert themselves in order to survive and grow. When competition is severe, only excellent companies survive. Competitive excellence derives from managerial excellence. With the globalization of markets, managers have turned to the creation of world-class supply chain operations, and the philosophies, approaches, tools, and technologies to assure excellence. Globalization changes the fabric of competition in a market and imposes new and more exacting requirements on companies and their supply chains. A firm competing in an international market is doing battle with the very best in the world. The realization that in a global market, a company must achieve excellence on five critical competitive requirements, namely, quality, cost, flexibility, innovation, and customer service has created a paradigm by which supply chain operations will be judged. This paper explores how companies can pursue competitive excellence in their supply chain operations by all paying attention to the five critical components referred above.

Introduction

The competitive environment has changed dramatically over the last three decades. The key concept to emerge over the last decade and present one is *globalization*. As the number of competitors increases, more and more firms attempt to improve their position, which puts pressure for continuous improvement on each competitor.

The existence of a large number of high caliber competitors depends on market scope. Market scope can be placed into three categories: Local, national, and international/global.

A local market exists when industrial and commercial activities are confined to a particular region of a country. Nearly all companies emerge as competitors in local markets.

Markets are national in scope when their products are manufactured and distributed within the boundaries of a given nation.

When production can be undertaken anywhere in the world and the product can be economically distributed and consumed anywhere else, the market can be said to be global in scope.

Production tends to be concentrated in a few international production centers and further globalization multiplies these centers. Globalization brings these competitively robust production centers into head-on competition with one another. Automobiles, pharmaceuticals, electronics, chemicals, petrochemicals, farm machinery, and civil aviation are all examples of global industries.

The global market represents the ultimate level of competition intensity. There is a persistent trend toward deeper globalization of markets that are already international in scope and also toward the increasing globalization of local and national markets.

Factors Propelling Globalization

The trend toward progressive and deepening globalization is irreversible, because it is powered by fundamental, deeply entrenched social, economic, and technological forces which are restructuring the world economic system. Here are some of the factors that are propelling globalization.

Economics of communication. Modern transportation technology and large-scale transportation have generated substantial reduction in transport cost on a global basis. Containerization and multi-modal transportation are some innovations that drastically reduced transportation cost. In most sectors of economic activity, transportation cost and effectiveness have ceased to be a barrier to trade.

Recognition of the advantages of international trade. Economic science has now firmly accepted the idea that healthy international competition energizes national economies. Protectionism saps the competitive energy from national companies and causes them to become more and more inefficient and saddled with obsolete technology.

Economic performance of free enterprise economies. To the extent that free enterprise is proved to be a superior economic philosophy, it inexorably legitimizes liberalized trade.

Sustained global industrialization. Although poverty persists in many countries, industrialization is spreading across the world. International diffusion of technology, better education and a more complete and tested body of knowledge on management of development means that more and more countries are becoming industrialized.

Competitive Requirements of Global Markets

A company competing in an international market is doing battle with the very best of the world. One would naturally expect that the world-s best are all producing superior quality. Evolution to an international market weeds out inferior quality products. Companies that cannot constantly improve quality fall victim to international competition.

The customer gives high priority to quality but is not indifferent to cost. Precisely because the customer has a large number of products to choose from, he or she can pay more attention to cost or price. A global market is dominated by the lowest cost producers. In order to survive in a global market, a company must produce superior quality and maintain a favorable cost position.

Competitive flexibility, that is, the ability to change competitive position quickly and to redeploys resources in response to competitive threats or opportunities is now a key strategic requirement.

A global market is an uncertain one. Companies survive in an uncertain market by constant improvement, innovation, and creative destruction. Global markets belong to innovative companies.

Finally, globalization puts real power in the hands of the customer. The forces that are shaping the market are also shifting the balance of power in the customer's favor. The ability to serve the customer is a critical requirement for long-term survival, no matter the market.

As a market evolves from local to global, the competitive requirements of quality, cost, flexibility, innovation, and customer service become tougher. The classical trade-offs between the five competitive requirements are replaced by symbioses whereby the performance of each competitive requirement must create better leverage to perform the other.

The supply chain encompasses all activities associated with the flow and transformation of goods from the raw material stage to the end user, as well as the associated information flows (Handfield and Nichols, 1999).

The function of supply chain management is to: (1) Focus suppliers on improvements in quality, consistency, and usage, (2) use supplier resources to create new product or service features for a business customer with faster cycle time to market, and (3) manage all materials and reduce cost.

This paper will focus on how a company can pursue competitive excellence in its supply chain operation, on all five requirements of quality, cost, flexibility, innovation, and customer satisfaction simultaneously. The next section deals with the quality imperative.

The Quality Imperative

It is not surprising that the globalization wave that began in the late 1960s was paralleled by a quality wave. The customer in an international market can choose among a large number of high quality products. The global market functions in such a way as to force companies to produce ever higher quality levels.

Quality came to the forefront of management thinking in the 1970s and 1980s because international competitive pressures were weeding out companies whose products were not up to world standards or were severely penalizing those companies that were lagging behind the world leaders.

Search for Perfection

Excellent companies are driven by the search for competitive perfection. These companies and their employees are always searching for the perfect product, service, and production without errors, and products without defects.

It is this deeply ingrained belief that perfection must be sought that keeps the world –class organization learning and stretching to improve further. Companies that are searching for perfection keep looking for and finding ways to improve. One is struck by the fact that the world's best corporations keep improving their products and production systems. Improvement becomes routine, a way of life. Toyota receives 750,000 suggestions for improvement from its employees every year and implements an average of 40% of them. This means that roughly 1,000 suggestions for improvement are being implemented every day, and the rate has been rising over the last ten years. Continuous improvement takes the company closer and closer to perfection.

Quality in the Supply Chain

Quality is influenced by vendors in an important way. A company cannot improve on the quality delivered by its vendors except at great expense and effort. Vendor quality cannot be improved by in-coming inspection since inspection merely confirms the quality that already exists in purchased materials.

Toyota has received worldwide acclaim for its quality. Toyota spends eighty cents of every sales dollar on purchased parts. Intuition would lead us to conclude that 80% of Toyota quality is made or assured by Toyota suppliers. The strong emphasis that Toyota puts on developing very strong, quality-conscious suppliers and on insisting that all suppliers believe that vendor impact on per unit product costs is as high as vendor influence on quality.

Companies that are being managed to produce superior quality generally do business with suppliers that produce superior quality. The techniques and approaches that give a supplier decisive competitive advantages through its production systems are available to every company. Total Quality Management (TQM), Just-in-Time (JIT), Total Productive Maintenance (TPM), Business Process Reengineering (BPR), and lately, Six Sigma **all** focus on improving or radically changing the process, and on the perfect execution and mastery of basic management principles.

The challenge is to place those technologies within the framework of long-term development of the supplier capabilities.

Quality Certification

Certification verifies that suppliers operate effective processes by focusing on the outputs of those processes especially regarding quality. Evaluators look for clearly documented sequences of activities under tight management control. Certification identifies suppliers that can reliably meet quality delivery, cost, and flexibility targets. Supplier certification programs often conduct site visits by representatives from operations, management, purchasing, engineering, and cost accounting. This site visit studies such processes as:

?? Material handling systems
?? Capacity and production-planning systems
?? Scheduling and shop-floor control systems
?? Preventive maintenance programs
?? Product design systems
?? Quality management
?? Database management procedures
?? Housekeeping routines

The evaluation teams reviews available documentation for completeness and accuracy. They assess control procedures, evaluate specific statistics, and ask employees about process and corrective procedures.

International certification for ISO 9000 is also imperative if our suppliers want to be in the world market. ISO 900 standards are currently recognized in about 100 countries including Japan. They are not engineering standards for measurement, terminology, test methods, or product specifications. They are quality system process standards that guide a company's performance of specified reforms in the areas of design, development, production, installation, and service. They are based on the premise that certain generic characteristics of management practices can be standardized and that well designed, well implemented, and carefully managed quality systems provide confidence that the outputs will meet customer expectations and requirements. In the next section we discuss competitive requirements of excellence in the supply chain.

The Cost Advantage

The value that a company creates is measured by the amount that buyers are willing to pay for a product or service. A business is profitable if the value it creates exceeds the cost of performing the value activities (Porter, 1997).

Cost is always a crucial factor in a customer's decision to buy a product or service. Low cost comes from superior efficiency. Cost represents the monetary value of the resources consumed in producing a good or service. Efficiency measures how well the transformation activities that were undertaken to produce the good or service were organized, coordinated, planned, controlled, and otherwise managed. Low cost can be attained and converted into competitive advantage if the company achieves the following conditions:

?? Perform all value-adding activities more efficiently than its rivals

?? Perform front-end activities such as research, development, and engineering in such a way that they enhance the efficiency with which downstream activities are performed

?? Link into efficient suppliers, thereby using them as a source of cost advantage

?? Eliminate all useless or non-value-adding activities (waste).

Traditionally, economies of scale and market share were seen as the major source of cost advantage. However, it is now known that large scale is no guarantee that costs will be low, because scale increases complexity and bureaucracy, which are major sources of inefficiency.

Eliminating Waste in the Supply Chain

Supply Chain Management is designed to maximize the value of dollars spent in purchases, materials, and services (Riggers and Robertson, 1998).

Every activity performed by an industrial or commercial enterprise in the supply chain is potentially a source of cost advantage. The first line of attack in a strategy to reduce cost is to identify and eliminate all competitively useless activities, that is, those that add to cost without creating value for the customer. Wasteful activities should be easy to eliminate once they are identified and viewed as waste. A basic just-in-time (JIT) principle is:

$$\text{Actual Cost} = \text{True Cost} + \text{Waste}$$

How does one arrive at the true cost? The true cost comes from trouble-free operations of the best technology available, and is a potential or target that must be rigorously pursued by management. The following are some examples of waste elimination that could be undertaken in the supply chain.

Waste of Overproduction. Producing more than what has been sold or is immediately to be sold creates inventories that are a plague! Overproduction occurs either because known demand is produced ahead of time or because production is done in the hope that future demand will deplete what has been produced.

For a business that has a strong seasonal sales pattern, an overstocking strategy could be the least-cost option. However, one has to carefully evaluate the level of overproduction to see whether it is profitable given the extent to which sales are seasonal.

Much better results can be achieved by investing a little bit more in market analysis and forecasting so as to find out what demand is likely to be. If a company cannot develop a reasonably good idea as to what the demand for its products is likely to be a few months into the future, either it does not understand its market or the product is a very bad one. Overproducing will not solve these problems.

Waste Due to Overbuying. Overbuying results from either buying too much (more than is immediately necessary) or buying too early.

Buying larger quantities than necessary is usually justified on the basis that high fixed transportation and ordering costs as well as quantity discounts on large purchase lot sizes generate substantial savings. These arguments are based on false notions of cost where inventory holding cost – and the negative impact of inventory – are often totally ignored.

The performance analysis and control system used by most companies is also responsible for this kind of thinking. Purchasing managers are hardly ever evaluated on the cost of holding inventory!

Marketing sometimes puts pressures on production to accept last minute changes in promised delivery dates, while rush orders and specials seem to be the rule rather than the exception. The results are a master schedule that cannot be planned, controlled, and executed reliably, creating deterioration in customer service.

Overbuying is also done to protect against unreliable vendor performance. A well-planned and executed supplier development program not only broadens the supplier base but also stimulates existing vendors to improve their performance.

Waste Due to Work-in-Process (WIP). Actually, very little of what is referred to as WIP is in fact in process. 99.9% of what is traditionally referred to as WIP is work that is not being processed, but just lying idle between two operations. Tremendous improvements in operating efficiently can be gained by managing to reduce WIP inventory. WIP inventory adds uselessly to the lead-time that can be promised to customers. Moreover, WIP inventory hides in-process quality and machine reliability problems. Eliminating WIP inventory is a necessary step in the pursuit of total quality, efficiency, and customer service. The most powerful set of tools available to the company that wants to bring about reduction in inventory is Just-in-Time (JIT) programming.

Waste Due to Transportation. There are two categories of transportation. There is external transportation that links a company to its suppliers and customers, and internal transportation that links various stages in the company's own manufacturing and distribution systems.

Waste in external transportation partly derives from poor plant and warehouse location decisions and supplier choice. Plants, warehouses, and supplies that are located far from markets can add substantially to transport time and cost.

Waste in internal transportation is more amenable to managerial action. Conveyors, AGVs, and other glamorous technologies only serve to hide waste and perpetuate it. When management decides to build a large plant in order to achieve scale economies and low cost, it is in fact creating high fixed costs, large lot production, and high levels of WIP, raw materials, and finished goods inventories. When WIP is excessive, the space that it uses increases the distance between work centers that would otherwise be close or physically integrated. Transporting goods between these works centers requires conveyors. But conveyors are not the ideal because they are one stage removed form direct physical process integration. If one were to eliminate or significantly reduce the WIP, very few conveyors would be necessary to achieve process integration.

Waste of Human Resources. People are the most precious and versatile resource that any organization can have. Companies that tolerate, ignore, or do not try their utmost to eliminate waste in human resources are building their future in questionable premises.

Douglas McGregor gave us some lasting ideas that are still relevant today (McGregor, 1960). According to McGregor, every manager makes a core set of assumptions about human nature which conditions all managerial actions in human re source management (HRM). He placed these assumptions at opposite ends of a scale and called one set Theory X and the other Theory Y. Theory X views people as being innately lazy, irresponsible, shunning authority, desiring to be controlled and motivated by money. Managers should use close supervision and a strong authoritarian style of management. Punishment should be dispensed when goals are not met. It is management by fear, by being tough.

Theory Y takes the opposite view that people are naturally industrious, that they seek responsibility, authority, and autonomy and that they are intrinsically motivated to look for challenging work. Management must be participative and collaborative, rewarding people with recognition and other positive reinforcements, and avoiding punishment. Management must manage by being liked, by being good.

When one makes assumptions like those adopted by Theory X, one gets hung up on labor idle time and variance reports (even though labor is not more than 10-15% of the total cost in our days) and ignore the real significant issues.

Theory Y shows the need to mobilize the labor force into creative action, to have people to use their creative thinking potential to the full.

This is employee self-management in action, and every company that is achieving superiority in the world scene has simply learned to do it better than its competitors. Waste in HR is waste in using the creative power of the total human being individually and in a group setting. It is the most vicious and wasteful waste. Idle time is a non-issue or at least a very insignificant one.

Waste Due to Excessive Overhead. Waste in the HR leads to waste due to overhead. Overhead exists because top management is trying to put a head (supervisor) over a worker that it assumes has no head or simply does not know how to use it. When management creates numerous levels of staff and supervisors in an unproductive work force, it sets the stage for creating a vicious circle of self-fulfilling prophecies. Many companies create staff where the only reason for existence is to coordinate and communicate with other staff.

Workers that are well trained, motivated, and encouraged to be autonomous do not need myriads of supervisors looking over their shoulders. The more workers are supervised, the less they have time for productive, creative work. A manager who has to supervise four people in an eight-hour workday must spend two hours supervising each and robs his subordinates of the precious hours of time that could be deployed creatively to do the job better. Workers will need little or no supervision when management shows confidence in their creative abilities and trains them accordingly.

Waste Due to Bureaucracy. Bureaucracy is created by management obsessed with control. According to Parkinson's Law, work increases to fill the time allocated for it. There is another consequence of Parkinson's Law. The absolute amount of useful work decreases as the amount of useless works increases. It has been universally observed that management (bad management) naturally gravitates toward report writing, implementation of formal procedures and rules, documentation, and the creation of committees, all of these under unnecessary deadlines. To accomplish all the above, a formal bureaucratic structure becomes embedded in the simple informal and flexible structure that have been the hallmarks of entrepreneurial organizations. Bureaucracy has become endemic to many companies, even those that achieved world-class status. In many companies, managers spend better than half of their time attending meetings and another big chunk of time filling out forms, writing, or reading reports. Companies today are awash in reports, memos, and procedural manuals. There are numerous cases where executives spend days poring over volumes of reports written by staff in an effort to solve a problem and the information upon which the final decision is based was contained on a single page.

Bureaucracy is the enemy of flexibility and speed of response to performance signals, and so, it must be significantly reduced or eliminated.

Waste in Equipment and Facilities. Waste in equipment is caused by long set-up (changeover) times, unplanned downtime, quality problems (in process), slow or no feedback on equipment abnormalities, and poor operation, policies and worker training. When technology is changing rapidly, it is difficult to find any piece of equipment that will not be obsolete after five years, if there is not a strong preventive maintenance and revamp program. All these causes of waste in equipment can respond to managerial actions to eliminate them. The estimate for American industry is around 30% waste in equipment. Imagine the impact on the key financial performance parameters of a company, if its investment in equipment was cut by 30 percent. Depreciation charges, asset turnover, breakeven point and equipment related costs such as maintenance would decrease. The 30% could be used in other businesses or a 30% increase in sales could be achieved with little or no capital expenditure. Many companies would double their profits if they increased capacity utilization by 30 %.

Waste Due to Bad Quality. Quality was covered before in this paper and therefore, we will not elaborate on its negative consequences further. Suffice it to say that once one has understood what waste is, it becomes clear that every defect is a waste. The only acceptable level of defects is zero and the only quality cost minimization strategy is rigorous bad quality prevention.

Let us now turn to address issues of flexibility in the supply chain.

Competitive Flexibility in the Supply Chain

A company in a global market is often required to redeploy resources quickly so as to respond to competitive threats or opportunities. In international markets, response times are short because there are many world-class competitors that are able to quickly exploit a company's strategic weaknesses.

Largely in the 1980s, manufacturing organizations grew increasingly more flexible and responsive to modify existing products and processes in response to customer needs. And, in response to ever-changing customer needs, new products and processes were quickly developed.

One example in the automobile market illustrates the point. Up to the mid 1970s, Volkswagen in Germany was manufacturing world-quality cars in its chosen segments and the company was also cost/price competitive. The company's position as an international automobile manufacturer was solid.

During the late 1970s, the major Japanese manufacturers made the necessary strides to improve quality. Moreover, they were also more efficient producers, and were therefore able to deliver better quality at a lower price in the same market segment where Volkswagen competed. In addition, spiraling wage rates in West Germany during the 1970s and 1980s caused Volkswagen to become a relatively high cost producer of car in its market niche. Although the company's quality did not worsen, an unfavorable cost position, coupled with improved Japanese quality meant that it was no longer able to deliver acceptable value to its customers. Its market share tumbled and since the mid 1980s, the company embarked upon a massive restructuring program to cut costs. Volkswagen management became acutely aware that they had to find ways to keep the cost of their cars in line with major world-class competitors.

The notion that the car market is an oligopoly flies in the face of reality. GM, Ford, and Daimler Chrysler are fighting the battle of their lives for survival. In the case of automobiles, the three oligopolistic markets in North America, Europe, and Japan link to form a fiercely competitive market. The concepts of monopoly and oligopoly appear to lose much of their significance when applied to a global market.

Flexibility is necessary because an international market is fundamentally uncertain. There are many widely dispersed competitors, each stretching to improve or retrench its position in the market.

Breakthroughs are more frequent. The sheer number of competitive moves is such that they cannot be anticipated so as to plan preemptive attacks. The point must be emphasized: a global market is an uncertain one.

Companies survive in an uncertain market by continuous improvement, innovation, and creative destruction. In the next section we turn to the competitive requirement of innovation in the supply chain.

Innovate or Perish

Innovation is a company response to actual or potential changes in the marketplace. The faster the pace of change, the more there is a need for the company to innovate.

Innovation is a proven strategy to deal with uncertainty where future market and technology developments cannot be anticipated with reasonable certainty. The only logical response is to innovate. To move forward, a company must generate research, develop, and try untested ideas. The first company that has some evidence that a new idea has merit can reap the benefits of being the first to implement the suggestions. Competitive excellence can be attained only if top management creates the internal environment–values, organizational structures, compensation and promotion systems, performance measurements, and evaluation policies-that will encourage people to generate and experiment with new ideas and also gives them the resources and authority to test and bring them to fruition if possible.

Innovativeness in the Supply Chain. Innovativeness, desire to improve, and a fiercely competitive spirit come naturally to vendors that put emphasis on satisfying the customer. Innovation is stimulated by the will to increase value for customers and to keep doing so as long as the vendor is in the chosen market.

A vendor that stops innovating very quickly loses the ability to keep delivery the best quality at the lowest possible price. Companies that are in business for the long haul will only choose vendors that will likely be in business in the long run.

Excellent vendors then, pursue quality improvement with relentless zeal. They drive hard to surpass customer reprints and will sometimes lead their customers in quality improvement.

The first question a company should ask about a vendor is not whether the price is low, but whether all its resources are marshaled to produce to exacting quality standards all the time and every time.

The Powerful Customer

Globalization puts real power in the hands of the customer. Managerial actions that produce lasting and sustainable competitive advantage or superior performance must be driven by the desire to satisfy the customer. All companies that have achieved competitive supremacy have made the customer the heart and soul of the business. There can be no enduring competitive excellence without the constant and permanent concern to attract, satisfy, and keep the customer. The business must exist for the customer and it must make total customer satisfaction its ultimate goal.

The world's best-managed corporations come to understand their customers and try to understand them better and better. For these companies, customer service is not a platitude for broken promises, but rather a conscious, deliberate effort to solve the customer's real or perceived problems.

In depth customer orientation shows up as total customer management. The company sees its job as more than merely selling a product. Much effort and resources are invested in understanding the customer's needs before the sale and in solving problems that come up after the sale. In the world-class company, the customer service department deals with and solves only a fraction of the problems that come up, because the whole business is involved with the customer. Customer consciousness and orientation permeate every organizational structure and are deeply embedded in the corporate philosophy and value system.

Tying it All Together

The realization that a company in a global market must achieve excellence in the five critical competitive requirements of quality, cost, flexibility, innovation, and customer service has created the need for a paradigm that links these requirements, resolves the apparent contradictions, and highlights the symbiotic relationship between/among them. The paradigm is Time-Based Competition (TBC). TBC is predicated on the notion that time is the most significant, overarching competitive requirement in any market, and that, at the most fundamental level, competitive means the ability to do things faster than one's competitors. TBC makes a direct and strong link between time compression and improvement in the critical competitive requirement of quality, cost, innovation, flexibility, and service. The whole organization must be made to focus on time as the major source of competitive advantage. A company is time-based competitive when the drive to compress time permeates all its structures, strategies, internal processes, systems, and policies. The performance measurement and reporting systems should include times as a significant measure of strategic and managerial performance.

H. James Harrington, in Business Process Improvement: The Breakthrough Strategy for Total Quality Productivity and Competitiveness, developed a process for reducing cycle-time in the supply chain of six steps; (1) Establish a cycle-time reduction team, (2) develop an understanding of the given supply chain process and current cycle-time performance, (3) identify opportunities for cycle-time reduction, (4) develop and implement recommendations for cycle-time reduction, (5) measure process cycle-time performance, and (6) conduct continuous improvement efforts for process cycle-time reduction efforts.

The benefit of being a time-based competitor is felt both internally and externally. The external benefits are: higher quality, quicker customer response, technologically advanced products and better cash flow. The internal benefits are: simplified organizations, shorter planning loops, increased responsiveness, better communication, coordination, and cooperation between functions.

Conclusion

The world's best companies have demonstrated that there is no inherent irreconcilable conflict between the requirements imposed by a severely competitive market. The conventional thinking can be made to stand on its head of a company sets out to pursue excellence on all competitive fronts simultaneously.

The key word in global competition is excellence. Excellence in the supply chain comes about when superior quality is used as a weapon to d rive costs down and when innovation and continuous improvement are agents for pushing quality up. Moreover, competitive excellence views innovation as the mechanism by which flexibility is sought.

In an innovative corporation, technological change is a habit and innovation the norm. Finally, corporations that are serious about customer service deliver everything they promise and promise nothing that they cannot deliver. The company must listen to its customers and solve customer-related problems with the utmost urgency, rather than be the problem or a major source of headaches for the customer.

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Singapore's Foray into Bangalore, India: In Pursuit of Location Specific Advantages

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Abstract

Singapore's regionalization stratagem led to the establishment of industrial parks in China, India and several South-East Asia countries. The strategic intent behind these overseas projects was two-fold: exporting Singapore's competencies such as management know-how, technological capabilities and corrupt-free administration to regions where such positive factors were lacking and secondly, exploiting comparative advantages that each region had to offer. This paper complements our research on Singapore's flagship projects in Indonesia and China, by investigating the foray into India, through the technology park in Bangalore. It evaluates the location-specific benefits that the site has to offer, primarily in terms of abundant and low-cost labour resources. This study is enhanced by in-depth case studies of a cross-section of companies in the park. It finds that, while location-specific merits abound, much of these have not translated to direct benefits to Singapore, largely due to socio-political problems that continue to plague the host environment.

Introduction

Despite its resource-constrained domestic environment, Singapore has achieved significant economic growth by focusing on its core-competencies. Singapore's infrastructural abilities, technological know-how and favourable reputation among foreign companies, coupled with its constant economic reform programs played a significant role in attracting foreign direct investment into the city-state. Such a move started as early as the mid-1960s which saw the beginnings of the Singapore government's aggressive approach to woo foreign MNCs to fuel the city state's economic development (Chia, 1986; Pang, 1987). However, while much of Singapore's initial growth relied upon such inflow of foreign investment, a reversal of trend was being observed by the mid 1980s. Rapid economic growth and liberalization of foreign investment controls in the Asian region presented Singapore with foreign investment opportunities for developing its external economy, locally knows as the 'second wing'. This second wing offered immense opportunities in the form of location-specific resource advantages that were either limited or totally absent in the city-state. Singapore sought to counter is own resource-deficient status by leveraging on such advantageous economic resources of neighbouring countries.

The regionalization program saw the establishment of industrial parks in the region that simulated a 'Singapore-styled' business environment in the emerging economies (Perry and Yeoh, 2000; Sitathan, 2002). Regionalization was intended to create economic space for local and Singapore-based multinationals to redistribute their resource-dependent operations, and to upgrade their operations in Singapore to higher-end activities, utilizing the unique set of benefits and competencies offered by each location. Designed to accommodate resource-dependant operations' of firms, it was envisaged that these industrial parks would enhance the competitiveness of Singapore-based companies that redistribute particular operations to reap location advantages from the regional sites. This not only enhances the cost-competitiveness of firms, but develops Singapore as a high-value investment hub with strategic linkages to resource-abundant locations in the region. To augment the location advantages of the strategic sites, Singapore lends its reputation and competitive strengths in infrastructural development and management to the regional sites.

To provide the context for this discussion, the theoretical considerations underpinning the project in Bangalore are sketched in the next section. The following section takes a closer look at the progress of the International Tech Park (ITPL), and examines the challenges confronting this flagship project. The analyses were further reinforced by in-depth case studies of the Park's tenants. The final section considers the implications of the new evidence to Singapore's broader regionalization initiative.

Theoretical Considerations

Dunning's Investment Development Path

Singapore's move towards regions outside its shores accompanied by heavy outward foreign direct investment, after being at the receiving end of substantial foreign investment into the country for more than two decades can be explained by Dunning's Investment Development Path (IDP). Dunning (1981, 1986) and Narula (1996) argue that a country's net outward investment (NOI, outward FDI minus inward FDI) is systematically related to its economic development. The IDP conceptualises a U-shaped relation between economic development and a county's net outward investment position. It suggests that countries tend to go through five main stages of development, that is, there are consistently observable patterns of structural change congruent with development, and these changes have systematic relations with patterns of FDI.

As economic development takes place, net inward direct investment will first grow and then decline. In the earliest phase of such inward capital flows, a country's infrastructure will be inadequate to support such inward investment. However, such investment will not only be supported but will continue to increase as economic growth occurs. A parallel can be drawn between the above description and Singapore's developmental period during its first two decades of existence (from the mid-1960s to the mid-1980s). The city-state experienced a similar increase in inward investments with an increasing growth rate. In fact, its long-established stratagem of economic development through foreign direct investments is well documented (Chia, 1986, Pang, 1987, Yeung, 2001).

Dunning also states that such inward investment will help create firm-specific assets that would allow outward direct investment. However, in backward regions it will take longer to accumulate such assets in order to initiate any kind of outward capital flow (Caves, 1996; Dunning, 1988). Over time, learning-by-doing will this process to evolve and outward FDI will emerge. Invariably, with the reversal of trend propelling investments outward, the country will experience an erosion of its absolute cost competitiveness, thus reducing the incentive for inward investment and further increasing the incentive for outward investment. The scenario in Singapore followed the same trend with rising business costs in the mid-1980s crippling the island and diminishing its cost competitiveness. However, with the city-state becoming wealthier it looked to channel its financial resources in the form of outward investments in order to retain its competitiveness. Such a move manifested in its regionalization strategy. This growth in outward investments demonstrates Singapore's determination in strengthening her economic prospects and further advancing in her economic development process. This growth in outward direct investments is evidenced in Table 1.

TABLE 1: SINGAPORE'S TOTAL DIRECT INVESTMENT ABROAD BY DESTINATION
(MILLIONS OF S$, STOCK AS AT YEAR-END)

Destination	1996	1997	1998	1999	2000
China	11.5	13.8	16.1	15.4	16.3
Malaysia	17.3	11.8	11.4	9.2	10.1
Hong Kong	10.8	10.7	10.1	11.2	8.4
United States	4.7	3.8	4.1	4.5	6.5
Indonesia	7.0	8.6	5.9	5.9	5.8
Mauritius	0.7	3.3	4.3	3.7	4.5
British Virgin Islands	2.6	3.8	5.3	5.2	4.2
Liberia	4.2	5.2	3.5	2.6	4.0
Total (%)	**58.8**	**61.0**	**60.6**	**57.8**	**59.6**
Total (S$m)	**55,536**	**75,807**	**75,622**	**92,720**	**91,949**

Source: Singapore Department of Statistics

The Eclectic Paradigm

The subsequent and inevitable outward investment of any growing economy aims to procure, among other benefits, location-specific advantages in the host country, for the investing country. Dunning's IDP characterises economic development with the net outward investment position of the country and correlates government policy with economic development in determining the pattern of competitive advantages of foreign investors relative to those of local firms (ownership advantages or the O-advantage), relative competitiveness of local bound resources and capability of the country (location advantages, or the L-advantage), and the propensity of foreign and local firms to utilise the ownership advantages internally rather than through markets (internalisation advantages, or the I-advantage). Dunning's Eclectic Paradigm explains the above OLI model.

According to Eclectic Paradigm, foreign investment will occur only if it is advantageous to combine spatially transferable intermediate products produced in the home country, with at least some immobile factor endowments or other intermediate products in another country (Dunning, 1988). Simply put, the OLI-model must be satisfied. In other words, there needs to be a balance between the three criteria. Dunning goes so far as to comment that the OLI triad of variables may be likened to a three-legged stool, each leg supportive of the other and the stool is only functional if the three legs are evenly balanced (Dunning, 1998). In so far as the third leg completes this balancing it may be regarded as the most important. Given such a diagnosis, what comes across clearly is how the location-specific advantages associated with the Indian venture form the third leg of the stool, being the single-most important reason for Singapore's foray into India.

Traditional location theories dealt with asset-exploring activities which were designed to maximize the firms' current efficiency whilst identifying the transaction costs and benefits of neighbouring activities. Contemporary theories postulate that in locating their activities within a limited spatial area, firms maximize the benefits of dynamic learning economies at the same time minimizing transaction costs associated with space (Dunning (edited), 2000). Firms' strategic choice of location reflects twin aims; to not only transfer their resources to the host countries, but gain access to the available strategic assets as well (Lecraw, 1993; Chen and Chen, 1998; Dunning, 1995; Makino and Delios, 1996; van Hoesel, 1999; Frost, 2001). A tabulated form of the different types of FDI is shown in Table 2 and how these influence the location of MNEs' value-added activities.

TABLE 2: TYPES OF FOREIGN DIRECT INVESTMENT

Type of FDI	Some Variables Influencing Location of MNE Activities
A. Resource Seeking	1. Local opportunities for upgrading quality of resources and the processing and transportation of their output. 2. Availability of local partners to jointly promote knowledge and/or capital-intensive resource exploitation
B. Market Seeking	1. Mostly large and growing domestic markets and adjacent regional markets (e.g., NAFTA, EU etc). 2. Availability and price of skilled and professional labour. 3. Presence and competitiveness of related firms. E.g., leading industrial suppliers. 4. Quality of national and local infrastructure, and institutional competence. 5. Less spatially related market distortions but increased role of agglomerative spatial economies and local service support facilities. 6. Macroeconomic and macro-organizational policies as pursued by host governments. 7. Increased need for presence close to users in knowledge-intensive sectors. 8. Growing importance of promotional activities by regional or local development agencies.
C. Efficiency Seeking	1. More emphasis placed on B 2, 3, 4, 5, and 7 above, especially for knowledge-intensive and integrated MNEs activities. E.g., R&D and some office functions. 2. Increased role of governments in removing obstacles to restructuring economic activity and facilitating the upgrading of human resources by appropriate educational and training programs. 3. Ability of specialized spatial clusters. E.g.: Science and industrial parks, service support systems, etc; and of specialized factor inputs. Opportunities of new initiatives by

	investing firms; and entrepreneurial environment and one which encourages competitiveness enhancing cooperation within and between firms.
D. Strategic Asset Seeking	1. Growing geographical dispersion of knowledge-based assets and need of firms to harness such assets from foreign locations makes this a more important motive for FDI. 2. The price and availability of "synergistic" assets to foreign investors. 3. Opportunities offered (often by particular sub-national spatial units) for exchange of localized tacit knowledge, ideas and interactive learning. 4. Access to different cultures, institutions and systems; and different consumer demands and preferences.

Source: Dunning, 1998, p 53

Regionalization: Establishment of the Indian Presence

The regionalization endeavour witnessed the growth of Singaporean industrial parks in numerous countries such as Indonesia, China, Vietnam and India. However, this paper will focus on the latest regionalization venture in Bangalore, India. The move into India was initiated in 1994 and the timing could not have been better. The early 1990s saw India throwing her doors open to foreign investment as part of a determined liberalization procedure in order to boost economic growth, akin to what Singapore had done in its early years of development. Singapore's response was positive and led to the setting up of the International Technology Park (ITPL) in Bangalore, the country's IT capital.

Singapore hoped to gain a lot from the tremendous location specific advantages that India put forward. The cheap and plenteous availability of both skilled and unskilled labour, the abundant land resources, espoused with the cooperative and encouraging attitude of the Indian government would definitely translate into a myriad of advantages for the city-state, if it were to relocate some of its operations in India. The Singapore government not only recognised this golden opportunity, but saw something more in an Indian park than it had seen in some of its already established parks. The information technology boom accompanied by the vast disposal of IT facilities and highly-skilled software specialists presented Singapore an avenue for building a technology park wherein high-end activities could take place. Hence, while other parks engage primarily in manufacturing or "operations" activities, ITPL has provided Singapore with the unique set of advantages that blends low-cost and high-end activities at the same time.

The next section of the paper delves further into the International Tech Park at Bangalore, India, giving a detailed description of its functioning and characteristics. A micro-level analysis involving in-depth case studies of five in-house multi-national companies at ITPL are also presented.

International Technology Park Limited

Based on the perception that Singapore agencies have advantages in infrastructural development, ITPL was initiated as a real estate development in India. Located 18km away from Bangalore in India's Silicon Valley [i], ITPL is substantially different from the other industrial-township projects in Indonesia, China and Vietnam. While ITPL was set up with narrow objectives, using the basis that Singapore agencies have an advantage in infrastructural development in India, the other parks had a political objective to demonstrate the strength of the 'Singapore development model' and its transferability to other Asian environments. Another significant difference is the predominance of service and support operations in ITPL, as opposed to manufacturing operations in other industrial townships in Asia.

ITPL, launched in 1994, is the newest of Singapore's investments and is a forerunner for the new generation of Singapore-developed industrial parks in India. The idea was mooted by Singapore's Prime Minister Goh Chok Tong and India's Premier, P.V. Narasimha Rao, in 1992. Construction commenced in September 1994, and the park was officially inaugurated in 2000.The partners in the ITPL project are a Singapore consortium of companies[ii] led by Ascendas International, the Tata Group (India's largest business conglomerate) and the Karnataka state government in a 40-40-20 arrangement. The Karnataka state government has since reduced its stake to 6 percent, while the Singapore consortium and the Tata Group have increased their respective stakes to 47 percent each.

ITPL was marketed as an environment that “cuts through the red tape and bottlenecks that are a part of India’s infrastructure and operating environment” (*The Straits Times, August 8, 1999*). ITPL was slated to provide total business space solutions to multinationals and other conglomerates, within a state-of-the-art technology park. The park’s development consists of 2 phases. Phase 1, which includes the Discoverer, Creator and Innovator blocks, with built-up office, production and retail space, adopts the Singapore-styled, integrated ‘work, live and play’ concept. ITPL’s futuristic design comes complete with numerous amenities, facilities and support services, and includes residential apartments and penthouses. More distinctively, ITPL guarantees uninterrupted power supply and telecommunication facilities, immediate-occupancy business incubator space, and the formulaic ‘one-stop’ service. Phase 2, comprising the Explorer building, a replica of the Innovator, Built-To-Suit (BTS) facilities, is due for completion in early 2004. This phase will add a total area of 350,000 square feet to ITPL’s current built-up area of 1.6 million square feet. ITPL also houses the Indian Institute of Information Technology, which provides professional and skilled manpower for the park’s tenants.

ITPL’s first development phase is fully committed. The earliest clients included SAP Labs, First Ring and 24/7. The first 39 tenants started their operations in 1999, and created some 2000 jobs. To-date, there are 100 confirmed tenants, of which 93 are operational with 8500 employees (Table 3).

More than half the tenants are wholly or partially foreign-owned firms, and more than 70 percent are in software development, integrated circuit design, research and development and precision technology (Tables 5). ITPL’s tenants include global players like AT&T, IBM, Motorola, Sony, Texas Instruments, Citicorp and Thomas Cook. Operating profits have been registered, and ITPL is projected to break even within the next 4 years.

TABLE 3: INTERNATIONAL TECHNOLOGY PARK LIMITED
OPERATIONAL STATISTICS (AS AT JANUARY 2003)

General Information	
Scale of Development	About 70 acres
Developed Area	1.6 million sq ft
Total Investment Value	SG$200 Million
Confirmed Tenants	100
Operating Tenants	93
Area Taken Up	1.4 million sq ft.
Park Population	8,500

Source: ITPL, Bangalore

TABLE 4: ITPL – TENANT PROFILE:
BY COUNTRY OF ORIGIN

Country	**Percent**
USA	42
India	36
Europe	16
Asia	6

Source: ITPL, Bangalore

TABLE 5: ITPL – TENANT PROFILE:

BY SECTOR (JANUARY 2003)

Sector	Percent	Sector	Percent
Software Development	49	IC Design	3
BPO/ITES	24	R&D	1
Biotech/Bio-Informatics	3	Educational Institutions	2
Manufacturing	10	Others	8

Source: ITPL, Bangalore

ITPL's competitive advantages as an investment location have been discussed. However, the update has relied primarily on secondary data from official publications, press reports, etc. This stock-take cannot adequately reflect the differential impact of various pull factors on the investment decision of different types of investors (e.g. local or foreign), or the differential impact of different types of constraints on the operations of firms with different characteristics (e.g. ownership type, market orientation, establishment size). To obtain firm-level data, on-site surveys and interviews were conducted in December 2002 and May 2003. The next section presents case studies of five multinational companies in ITPL.

Case Studies

The companies were selected to reflect ITPL's diversity, and for their considerable presence in the park. The semi-structured interviews were designed to gather information on the push-pull factors that influenced the firms' decision to locate in ITPL. Other questions pertaining to the companies' views on the facilities and services in the park were culled from the open-ended questions. The characteristics of the firms are summarized in Table 6.

TABLE 6: SUMMARY INFORMATION ON CASE STUDY FIRMS

Company	A	B	C	D	E
Country	Japan	U.S.A.	U.K.	U.S.A.	Germany
Sector	Manufacturing Services	Business Process Outsourcing	Travel and Financial Services	Business Process Outsourcing	Inter-Enterprise Software
No. Of Employees at ITPL	50 - 100	800	5	12,000	500
Space Occupancy (sq. feet)	-	60,000	-	42,000	100,000

Source: ITPL, Bangalore

Case A– Manufacturing Services

Company A is a Japanese based company specializing in manufacturing machine tools and is one of the largest machining centres in Asia. The company has numerous centres in Germany, US, China, Brazil and Mexico, with the largest and most important ones located at Singapore and Japan.

The company, currently located in Bangalore at the Export Promotional Zone is a completely Singapore owned venture initiated to support its operations in Singapore. Operations at the Indian centre primarily circumscribe around marketing services and application, light machining and unit assembly providing support to major operations at the Singapore unit.

Company A initially operated in a small office in Jayanagar in Bangalore city in 1994. When ITPL began operations in 1997, Company A was one of the first tenants when it moved into the newly opened tech park in the same year. ITPL was the obvious choice for the Company A to set up its office due to the infrastructural advantages and the quality assurance promised by the 'Singapore Park'. Company A boasts the status of being the first and only manufacturing company located at the park. Taking office space at the Creator block, manufacturing was limited to demonstrations to customers and unit assembly supporting its head office in Singapore.

Nearing five years of operations in ITPL, Company A vacated its ITPL location and moved into its new complex within the Export Promotional Zone, in close proximity to ITPL in 2002. This move saw ITPL convert its Creator block, initially a unit for manufacturing companies, to a world class office space. The prime reason for Company A's departure was its need for a cheaper and large area (10 -15 hectares) as opposed to ITPL's space restricted, expensive facility. One of the prime reasons why Company A was setup in India was to take advantage of the cost benefits that were lacking in Singapore and Japan. ITPL rentals would negate this advantage. ITPL rents are considered extremely high for manufacturing units, and are just about manageable for short incumbent periods for larger companies such as Company A. This is because such companies operate on low margins (approximately 10%) and require large amounts of space. Hence, when ITPL no longer proved suitable for the fast-growing manufacturing concern, it opted to move out.

Case B- Business Process Outsourcing

An American firm, company B is involved with e-services. Head quartered in Los Gatos, California and with operations at ITPL, the company is acknowledged as the industry standard provider in customer support services and solutions to Global 500 companies. It was founded by an experienced management team with proven expertise in delivering large-scale mission-critical customer support programs.

ITPL is highly suited for the company's operations. With its facilities catering to small and medium enterprises engaged in R&D and the service sector, the park has become a nesting ground for a large number of firms involved in Business Process Outsourcing (BPO). Located at the 'Creator' building of ITPL, company B is one of many such companies. Today, it has become one of ITPL's established tenants employing 800 employees, occupying 60,000 square feet. Company B has been operating at the ITPL since April 2000.

Company B's prime operations at ITPL include real-time customer service management and technical support to foreign firms. In fact, the facility in ITPL is the largest call centre in the state of Karnataka. Catering to customers such as AltaVista, the company has conducted successful programs such as outbound telemarketing, inbound phone customer service, inbound phone technical service, with service areas spanning countries worldwide, particularly in the U.S and Europe.

Operating globally, primarily through one-on-one telephone services and web based customer assistance, 24-hour connectivity and service is a necessity for the Company. The ITPL facility meets all expectations on this front. The regular power supply, the 24-hour speedy connectivity and the plug and play services of ITPL all combine to form the unique selling proposition of the park that continues to attract a plethora of companies in the BPO industry.

An added advantage is seen in the fact that the city of Bangalore abounds with excellent schools and universities. This coupled with the high standard of education, serves as a continuous source of English-speaking-skilled employment for the call centres located in the park. The company sees this pool of potential employees as an added advantage in carrying out its operations in ITPL.

Case C – Travel and Financial Services

Company C is one of the world's leading international travel and financial services groups and serves over 20 million customers a year. It provides services at 4,500 locations in more than 100 countries and employs over 20,000 people.

Establishing itself in India as early as in 1881, today, the company's Indian subsidiary has a network of 54 locations in 16 cities across India and is the largest travel and financial services group in the country. Foreign exchange, corporate travel, leisure holidays, travel insurance and credit cards form the core activities of the company.

Company C is one of the very few companies that was approached by the ITPL management itself to set up shop at the park. On the management's behest, the company acquired an office within the park's premises largely to provide money-changing activity. Its core operations within the park, therefore, include ticketing and foreign exchange services.

Compared to some of the other tenants, company C seems a smaller entity with only 5 employees for its office in the park. However, it has managed to secure a large customer base largely due to the fact that it is the only tenant providing such services within the park. Moreover, the company also caters to an increasing number of firms outside the park who find it convenient to visit its office in the park, which is in close proximity, instead of approaching its other branches placed in the city-centre.

Case D - Business Process Outsourcing

Incorporated in May 1999 as a 100% subsidiary of the Virginia-based parent company, Company D spreads over 42,000 square feet of ITPL office space and employs 12,000 employees. The American parent is considered a frontrunner in integrating the expanding capabilities of information technology, telecommunications and the internet, by providing services such as voice-based services, internet services, back-office functions, and interactive teleservices.

Similar to Company B, Company D's operations within the park largely focus on Business Process Outsourcing, which include both inbound and outbound customer care. As a result of its medium size and the nature of its operations, the company seems unlikely to procure additional office space in the near future. The company, therefore considers itself to be well suited for the park.

As in the case of other companies in the same industry, Company D, too, cites the permanent power supply, 24-hour connectivity and supporting infrastructure as the vital factors that prompted it to situate in the park. This is because 24-hour customer support is expected from Company D's overseas clients. The company also employs a sizeable portion of the IT graduates that Bangalore churns out every year.

In addition to the above, according to a company official, the firm perceives ITPL's excellent and professional support services and maintenance programs as a huge advantage that gives it an added edge over its peers that are located elsewhere. Such benefits have been the direct result of the Singaporean styled management. However, the company has expressed reservation over the numerous other call centres making their way into ITPL to make use of the same advantages, which escalates into other problems such as heightened competition, further sharing of resources and the "the pool of entry level people getting smaller".

Case E - Inter-Enterprise Software

Company E is a well-known and highly reputed software firm. A wholly-owned subsidiary of an international software giant, it carries out similar operations as its German parent, that of providing collaborative business solutions and development of software. Its parent company is considered the world leader in the provision of business solutions and high quality software for all types of industries and markets and enjoys the position of being the world's largest inter-enterprise software company and the world's third largest independent software supplier over all, employing over 28,000 employees in over 50 countries. Initially an autonomous German IT company, operating in the Koramangala district in the city of Bangalore, company E was bought over by the aforementioned parent company in 1998. The change in ownership also saw a shift in location into ITPL. With operations of other companies at ITPL beginning only in late 1997, the company's establishment in 1998 made it one of the first occupiers. Today, company E is one of the largest tenants in the park, in terms of space occupancy, covering about 100,000 square feet (9,000 square metres). Even before moving into ITPL, the company had considered other city locations which were comparatively cheaper in terms of rentals, offering on-fourth of ITPL's rate. However, despite these other attractive locales, the company chose ITPL chiefly due to the some indispensable benefits that ITPL proffered, these being, regular power supply, state-of-the-art infrastructure, convenient and fast setting up facilities and excellent communication channels. In fact, while justifying the company's choice of ITPL, a company official had this to say: "For any company, ITPL provides excellent operating facilities, which brings about an increase in revenue. This increase in revenue is larger than the increase in costs (in terms of rent)". The company primarily undertakes software development activities within the park and functions as a 100% export unit. All its exports go to Germany.

After four years of operations, the company has decided to move out of ITPL. The decision was attributed to the company's rapid expansion, growing form a company of 70 employees to 500 employees in the span of the four years spent in the park. Ideally suited for small and medium scale enterprises, ITPL has been unable to accommodate the company's growing size and as a result space constraints within the park proved to be single-most important reason for the company to move out. With the aim of expanding its operations, the company seeks to move into a larger outlet. With rapid expansion, not only is there the need to move into larger premises, but the need to avail of economies of scale. ITPL, with its expensive rents thus proves highly uneconomical for a company seeking to enjoy economies of scale. All these reason contributed to its shift into an expansive new campus of 15 acres in area within the Export Promotional Zone itself, a stone's throw away from the park. Additionally, moving out of a multi-tenanted place into an individual complex allows the company to establish its own identity. However, given ITPL's unique advantages and the image and branding associated with it , Company E has still retained come office space park's new BTS (Built-To-Suit) facilities.

Discussion

It must be noted that ITPL's provision of a large number of the above-mentioned location-specific advantages can be attributed to the unique style of the park's concept that incorporates both the local Indian advantage as well as the exported Singaporean advantage. With India opening its economy to foreign nationals, there has been a flood of multi-nationals coming into the country to exploit local resources particularly in the form of cheap and abundant labour. Companies like Company B and Company D, who operate call centres using a large number of Indian graduates, cited the availability of such cheap and plenteous labour as providing them with an edge over call centres in other regions. Of course, India's liberalization policy also serves to provide immense opportunities to such MNCs who are looking to enter the growing and untapped Indian market. In fact for company C, which is in the travel and financial service sector, having a large market to cater is key, since it operates on relatively low margins. It cites the vast Indian market as the most attractive factor that led to its establishment in India. Hence, resource-seeking and market-seeking motives act as primary drivers behind the decisions of such MNCs to begin operations in India.

However, while India presents lucrative opportunities, numerous problems continue to plague its environment. These include: unreliable infrastructure, extensive red-tapism, corruption and inefficiency that continue to prove to be deterrents to incoming foreign nationals. Moreover, the initial government support which served as attractive factor during the beginning of the venture has diminished. This is indicated in its reduced stake in the project. It is with the objectives to counter such inadequacies that Singapore embarked on the ITPL project. The Singapore side has attained considerable success with ITPL by providing companies, (Indian, Singapore-based, and foreign companies) with infrastructural facilities, technology and efficiency that are characteristic of Singapore's business environment. Hence, ITPL also serves companies in search for efficient-seeking location-specific advantages. Company E perceives this technological and efficiency-based advantage as one that contributes enormously in its software development activities.

Dunnings' Eclectic Paradigm has also been extended to deliberations on the presence of immobile clusters of complementary value-added activities (Markusen, 1996) and the transactional benefits of spatial proximity. Dunning (2000) contends that the greater the degree of knowledge intensity of a particular activity, the easier it is for labour to migrate across regions or countries, the lower the distance related costs, and the more firms engage in FDI and alliance-related activities to augment, rather than exploit, their existing assets, then the more likely is it that national and micro regional economies will develop specialized centres of excellence. ITPL is gradually developing into such a specialized centre wherein high-value added activities are taking place. The statistic of more than half the number of tenants in the software and R&D sectors bears testimony to this. As firms' core competencies become increasingly knowledge-intensive the location in which firms locate their production, organization and use of assets emerges as a critical competitive advantage (Dunning, 2000). MNEs continue to seek locations (economic and institutional facilities) that are best utilizing their core competencies (Dunning, 1998).

Conclusion

ITPL proves to be a refreshing change in Singapore's series of overseas investments. It showcases a unique blend of high-value added activities performed at comparatively lower costs. The park has attained considerable success in furnishing Singapore with location-specific advantages. However, as mentioned in the above section, the location specific advantages don't come without numerous other limitations. Singapore's presence in the park thus goes a long way in eliminating many of these limitations so as to provide companies looking to settle at ITPL with an advantageous location. Hence, it is a combination of the proffered Singaporean experience and country-specific comparative advantages that help to attract corporations to ITPL.

Singapore's Positive Reputation:

ITPL's success hinges on the "Singapore-styled design and management" reputation. In a country where corporate image is of immense importance the Singapore presence contributes tremendously in enhancing this image. The city-state is world renowned for its management skills, disciplined efficiency and corruption-free administration. The effects of al these strengths can be seen at ITPL, where considerable premium is placed on the Singapore presence. As a result, the park has successfully leveraged on this reputation of reliable infrastructure to motivate companies to relocate to these areas where such facilities are anomaly. The park has been attracting investors with its formulaic one-stop service within a self-sufficient, self-contained environment, which is unburdened by inefficient administration. For example, ITPL is being used by many tenants to establish their brand-image, as there is prestige associated with being located in, what is locally known as, the "Singapore Park[iii]".

India's Location Advantage:

ITPL has provided considerable location-specific comparative advantage in terms cheap and plentiful labour. Its contribution also extends to the nature of labour provided that enable high value-added activities within the park, making readily available high-quality software developers and IT personnel, as well as a pool of competent graduates, for various operations within the park. India has been one of the biggest beneficiaries of the global shift of high-wage professional jobs to low-cost countries (Straits Times, August 2003). The supply of qualified, English speaking professionals at lower costs has given the country an edge in wooing foreign companies. The global economy today is increasingly based on low-cost labour which is being exploited by MNCs. In fact, the Singapore government has constantly recognised this low-cost competitiveness offered by countries like India which doubles as a potential and a threat. With liberalization efforts favouring the entry of MNCs in India, the government support and the influence of inter-governmental relations cannot be ignored. ITPL shares the characteristic of active government involvement, with the Indian counterparts being the Karnataka state government and the Tata Group, which, though private, is well connected with the authorities. The strategic alliances between Singapore's government-linked companies, and its counterparts in the regional sites, were instrumental in mobilizing the resources to complete these multi-million projects. Finally it must be noted that the sprouting of numerous other parks not only in India, but also in the vicinity as ITPL – parks such as Software Tech Park and Electronic City – has heightened the competition amongst these parks in trying to attract foreign enterprises. However, ITPL's differentiating factor lies in its Singapore connection which proves to be an important marketing edge over technology parks in the country.

References

Contact the author for a list of references

End Notes

[i] Indian universities reportedly graduate about 20,000 to 30,000 software engineers every year, and Bangalore has been a 'hunting ground' for Singapore companies and Singapore-based multinationals seeking low-cost IT specialists.

[ii] The Singapore consortium, Information Technology Park Investments Pte Ltd, includes RSP Architects, Planners and Engineers, L&M Properties, Sembawang Industrial, Technology Parks (a Jurong Town Corporation subsidiary) and Parameswara Holdings (the investment arm of the Singapore Indian Chamber of Commerce).

[iii] This was a constant refrain throughout our on-site interviews in ITPL in December 2002.

Section 6
Human Resources and Socio-economic Issues

Impact of Organizational Structure on People Who Work Within It
Gabriel Sánchez de Aparcio, Universidad de Guadalajara, Mexico

The State of Human Resources in the Slovak Republic Police Corps in the Light of Research Results
Robert Štefko, University of Prešov, Slovak Republic

Mexico: The Challenges of Human Development
Ignacio Medina, ITESO and Universidad de Guadalajara, México

Skill Shortages, Training Needs and HRD Strategies of MNC's in Mexico
Laura Iturbide, Universidad Anáhuac, Mexico

Human Development Investment in Mexico: Selected Indicators and Some Reflections
Rogelio Huerta Rosas, Ricardo Pérez Mora, Gabriel Arturo Sanchez de Aparicio y Benítez,
Universidad de Guadalajara, Mexico

The Relevance of Reference Groups for Mexican Americans
María Eugenia Pérez, Tulane University, USA

Human Capital Management in Malaysia: Preparing for Future Challenges
Ahmad Fawzi Mohd Basri, Universiti Utara Malaysia, Malaysia

Personalities Having Tolerance of Uncertainty
Tiina Hautala, University of Vaasa, Finland

The Impact of the Values of Top Managers upon their Subordinates' Values
Krista Tuulik, Ruth Alas, Estonian Business School, Estonia

Victim and Non-Victim Responses to Anti-Bullying Practices
Joanne D. Leck, University of Ottawa, Canada/ Bella L. Galperin, Rollins College, USA

A Comparison of Communication Satisfaction and Organizational Commitment among Public and Private Sector Employees in Malaysia
Che Su binti Mustaffa/Hassan Abu Bakar, Universiti Utara Malaysia, Malaysia

The Determinants of Poverty in Mexico: 2002
Jorge Garza-Rodríguez, University of Monterrey, Mexico

Urban Health Insurance System Reform in China
Xiaohui Liu, University of International Business & Economics (UIBE), China

Industry Strategy Meets Civil Society in Asia: Confronting Regulation of Cross-Border Media
Amos Owen Thomas, Griffith University, Australia

Impact of Organizational Structure on People Who Work Within It

Gabriel Sánchez de Aparicio
Universidad de Guadalajara, México

The power became organization,
and organization was installed in subjects.
Subjects are the power in the organization. *Javier Uriz Urzainqui*

Abstract

Working together effectively bringing human resources in a methodic way, and trying to reach the same goals is what we call an *organization*. There is no doubt that success of culture and civilization is in good part the result of organizations, in as far as humankind events refers. Organization has a lot to see with human needs and characteristics, and as Javier Uriz (1994: 113) says: "it is a methodic and protector cosmos: Defines 'us'; guides energies and aggressiveness of the most ambitious members; and gives everybody the possibility to reach goals". That is how during the first years of life, in the social and familiar ambits, we identify ourselves as "we" in front of "others"; during adolescence the "I" comes out weakening the "we" and, in adult life the "we" strengthens in the context of organizations as we become a part of them and assume the sense of belonging we had since our home life. It means the will to establish a formal order. If we deeply examine the purposes that make possible to create and operate any organization, since the most basic and simple as can be the family up to the most complex multinational, they will always be for satisfying human needs that are impossible to reach by the lonely man. This concept applies for everyone, from the ones in the top of the organization to the center teams and the ones who operate in the inferior level.

Introduction

The organization is supposed to exist for the welfare of those who make decisions, the ones who interpret them and the ones who work on them. In a word, it is for one and each of its members. The formal established order, the form of an organization – the structure with its parts – has the purpose to anticipate and, in a certain way, to establish how people must behave in order to reach the goals and objectives in common; however, it must not be done without previously considering the next three factors:

a) The characteristics of human behavior.
b) The inter relationship that comes out among individuals and structure, and vice versa.
c) The production of structure from the strategic planning and, in this case, NO vice versa.

The directors or managers who decide the organizational structure of the institution or enterprise should consider, in a wide way, how is the whole organization structured, as well as taking care of all details in the integrating elements. All this considering that the bureaucracy (with its consequent clumsiness and slowness), or the efficiency of the whole institution, passive life, failure and inefficiency, – or even its death – or strength, efficient work, and success…life, will depend on such structure. [1]

Parts of organizational structure design.

When the structure is set and drew or displayed in a flow chart, the organizations and the individuals' welfare is being decided. These are far-reaching decisions which affect the institution's efficiency and efficacy as well as the people, their jobs, their functions, responsibilities, feelings and motivations; in a word, the whole organizational culture. These decisions will always refer to the next four orders:

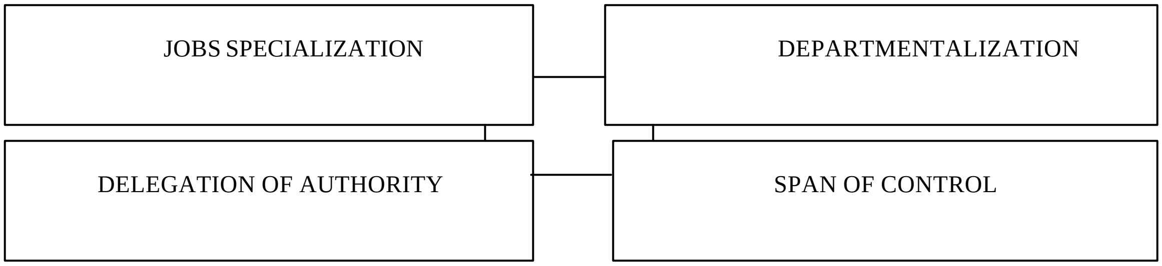

CHART 1

Let us quickly explain these four parts of structure in an organization and some of the important factors, as if we know them it will be easier to judge any organization.

Jobs Specialization

It's the most common and visible factor in giant enterprises and less evident in small and middle enterprises [2] (PyMES for initials in Spanish) and does not require much presentation. The organizations are mainly composed of a set of positions and employments with different degrees of specialization. It is appropriate to comment two opposite poles of continuum that are present in the employment specialization organization. A) Looking for benefits in dividing the job, the decision will be between the scientific impersonal administration, which makes it complex and produces a possible sophisticated image, on one side; B) and on the other side, the artistic or familiar, which qualifies it like simple and makes it looks natural.

Delegation of Authority

The ability to congruently make decisions according to rules in an organization is known as authority. That is to say, when we talk about authority we refer to the authentic power an individual has according to his/her position in the organized social structure. It implies an organization, a hierarchic order, a competition range or field where such authority is applied. To have specific rules and patterns, to separate the position from its property. Authority endures a conception and a style in the use of power: it can be distributed in all the structure or retained in hands of a few managers. If we go through the organization flow chart and the attributions in the use of power we will be able to see if it is centralized, where it is centralized, or if there is a balance in its distribution. It can be schematically represented by a line, a *continuum*. When power is not centralized, the ability to decide and act is given without previous authorization of the immediate boss or superior manager. This way of working authorizes bosses in lower levels to decide how to identify and solve problems. On the other side of *continuum*, we have centralization which means that power is concentrated in one or few managers making it necessary to ask for authorizations, multiple signatures, and more papers. [3] This structure comes to a bottle neck for decisions and bureaucratic ways are the same old thing.

JOBS SPECIALIZATION	
LOW	HIGH
DELEGATION OF AUTHORITHY	
NON CENTRALIZED	CENTRALIZED
DEPARTMENTALIZATION	
HETEROGENEOUS	HOMOGENEOUS
SPAN OF CONTROL	
WIDE	NARROW

CHART 2: CONTINUUM OF ORGANIZATIONAL STRUCTURE PARTS

In many leader organizations , the exit key is to solve the problem of power combining a minimum centralized capital decisions – in highest levels they only retain a few and very important focused in the organization's values -, and most of the decisions are decentralized and delegated. Concerning the use of power in organizations it is worth to comment two elements that can profitably coexist. The first one, on the other part is structural.

A) The control chain. It appears in relations between superiors and subordinates, from the highest to the lowest positions. It clearly specifies to whom everyone has to report, as his/her "on line" authority and manages communication at all levels. Usually the employee must report to only one person. When the relation directly contributes to the organization's, the department's, or the section's objectives and the superior manager has direct authority on the employee it is called "on line." When the relation only assists, recommends, suggests or advises the on line position, then it is the called "staff" due to the fact that it does not have power of control.

B) Nowadays organizations often use "empowerment" which we could translate into Spanish as "empoderdamiento" or "potenciamiento", or "fortalecimiento del poder". It consists in training both basic and operative employees in the production or in services, so they can have knowledge of more areas and develop more activities than those they normally do. At the same time, it prepares them to use power and make decisions without previous superior's authorization. The empowerment process can be used by the boss to increase subordinates' power. It is a process with the purpose of fortifying self - effectiveness and self esteem feelings among members of a group or an organization. It starts identifying and overcoming obstacles to increase power in certain members of the organization. The means used to reach this goal are: training, authority and functions delegating, providing information and the necessary resources. This way production, process control, and the need of quality become a part in everybody's work. Everything that improves quality and fulfillment is authorized. Empowerment is an important part on any total quality administrative program, as it diminishes outside motivations and extrinsic incentives and, cooperates to build the environment and the competitive organizational culture required by contemporary globalization.

Departmentalization

Department distribution is the structural result of joining tasks and jobs according to a logical base. Logical basis can be simple or complex. Simple are structures coming out from department division by functions, by products, by clients or consumers or by geographic distribution. They are complex when more than one logical base is used as it happens with the combined structure and with the one organized by techniques.

?? *Department distribution by functions, with logic rationality focused in specialization* has a better functioning when there is a steady atmosphere in the organization. It requires a solid control of techniques and operation. Communication could suffer and become the most vulnerable factor in the organization.

- ✍ *Department distribution with logic rationality base focused in the product* enables employees to apply their own skills and abilities. It is expensive because it needs one administrator or manager by product and there is a risk to be unnecessarily duplicated; for that reason, the giants such as General Motors (cars, etc.) or Procter and Gamble (Crest, Camay, Salvo, Ivory, Tide, etc.) use this kind of structure.
- ✍ *Department distribution with logic rationality established on the type of client* is logically guided to fill the client's or consumer's needs. A good example of this are the banks. The risk is to create many staffs to support the actions of the different departments in a first level bank.
- ✍ *Department distribution with logic rationality based on geographic distribution* is done when the organization has offices in many regions or in the whole country, or even in other countries and the clients' needs and characteristics are different. Offices, that have the power and the necessary authority to solve problems, are opened to attend each region or area.
- ✍ *Department distribution with combined logic rationality* is one of the mostly used because it is realistic. Takes advantage of interdisciplinary systems that can assemble their small structures to simultaneously attend services, client's needs, products, and geographic distribution. It frequently takes advantage of formal and informal social chains. They brake the barriers that classically separate departments and even the physical spaces become more common to operate the multidisciplinary

systems or for special projects. The executives usually share spaces with their employees and are available for all of them. It helps to reduce time in implementation and solution of projects.

- *Department distribution with organization by techniques as the logic rationality base* is in connection with development of products for specific dates or precise coordinated situations in space and time. It is temporarily created to reach the specific project "X" and the members team are specialists, or also multidisciplinary experts, as in the previous *combined logic base*. It does not properly have a structure by departments, but by projects and the employees rotate. The leader of project "A" can just collaborate on project "C". Between one project and another the ones who are free go back to the "excellence center office" for training, for being up-dated or for doing some other short tasks.

*** One of the most interesting examples of *combined logic rational base* is Hewlett-Packard. Its organizational structure is plain and very different from the pyramidal. Its opened and fellowship organizational culture seems to be one of the most motivating and attractive.

CHART 3

***The model of *logic rationality base by techniques* is the one of Hallmark Cards, which works in connection with the making products technique for special and precise situations such as the festivities of the annual calendar.

CHART 4

Span of control

It is usually the last decision taken when designing the structure, even though it is transcendent for the organizational culture. The control section is the jurisdictional space or place of which any boss is responsible. It consists on the number of people reporting to a leader, a boss, an administrator or a supervisor. It can be wide, - the flow chart is then plain - when many employees report to a same boss. It can be narrow if the boss has a small group of employees. There is not a formula to determine the ideal number of control sections, it depends on the boss' experience, on his/her personal qualities or on the intrinsic nature of positions or jobs he/she coordinates or supervises. Nowadays organizations tend toward the wideness of control sections to plain the structure so that decisions do not have to go up many administrative levels.

Importance and Parameters of Organizational Structure

As we have be seen, decisions that determine how to constitute the four essential parts of a structure in an organization or institution are fundamental, as fulfillment of all management and operative personnel depend directly on them. The highest level administrators cannot take their flow chart development superficially as it affects the whole organization. Many directors admit that, in contemporary world, their organization is clumsy, inflexible, and therefore, slow in adequate answers to challenges or innovations they face in the real world and their clients ask for. However, they frequently blame and say it is the personnel's fault as they are inept and don't know how to develop the proper strategies or services, they lack competitiveness, they are not motivated and they don't really feel as a part of the family. Be careful! The above mentioned points are the main problems of the organizational structure.

The structural organization must be consistent with strategic planning. It specifies the objectives and time to achieve them. The organizational structure specifies who must reach a goal and how to do it. Unfortunately many organizations try new strategies with an old fashioned organizational structure. When job is of poor quality, in time, product or service, we probably have a structure problem. Conflicts among departments or groups are suggesting a structure problem. There can be differences in objectives and poor knowing of the organization's mission, of its strategic goals, its plans to short, medium or long term. It is almost sure that the problem is structural if there is no good coordination among departments, if there is slowness to adapt, or they have arguments into changes, if responsibilities are not well established, or if the middle level bosses are asking about the main goals they must reach.

Organizational structure problems can be a disaster for the whole organization and risks its mission and strategic planning. The most frequent problems are: A) It can become a collection of departments or independent groups trying to achieve their own objectives with no coordination among groups. B) The strategies are given by the organization's structure, instead of making that strategic planning be the structure's factor. C) If the structure is the one that defines the strategic plans, then only the compatible strategies will seem to be acceptable, and one of the main administration principles will be lacking: strategic planning determines the organizational structure. It is important to consider that for the employee the way to see the job, the behavior, and the vision he has about the bosses is the image of the structure given by the organization.

There are three parameters easily identified which allow us to make an exact diagnosis about a good functioning structure in any organization, and find the differences with other forms of organizational structure. They are: formalization, centralization, and complexity.

Formalization

Can be pointed out as the degree of inflexibility or flexibility that describes any organization. This parameter says that in an organization communications as well as the normally applied procedures must be available, written down, and known by the whole staff to consult them when needed. In general, a professional and more systematic administration can be more formal, while a familiar or artisan is more flexible and less formal. In this sense the organizations that are interested in empowerment are less formal or rigid.

Centralization

As previously mentioned, this parameter, that separates centralization on one side of continuum and power delegating on the opposite pole measures whether ability to decide is concentrated or not in the whole organization Most of the modern organizations leave apart the extremes and try to combine centralization with power delegating. They have created different successful formulas.

Complexity

The complexity parameter rules the number of job titles and departments. As organizations grow up the jobs are naturally divided and more departments are created. Departments can be responsible of different or even dissimilar matters. However, if inside the organization there is high specialization, department distribution by product, with direct attention to clients, geographic distribution services and short or narrow control sections, the administration will complicate. It is implicit that as more complex is an organization more complicated its administration. Nevertheless, there exist organizations that have solved this problem making their units independent, providing authority —early empowerment—, standardizing quality since the control of row materials, regulating processes with a meticulous hygiene, the quickly distribution of products so they can arrive fresh to remote access places. And, first of all, trusting, preparing and promoting personnel's development as they are part of his/her own family and the company great family. This is what Bimbo the Mexican enterprise opened since the 40's, has been constantly doing with success.

People Integration in the Organization

I will finally talk about culture of relationship and cooperation inside the organizations. I know that what I am going to expose is not for the great public, because it is not usual in organizations; however, I am convinced that is the way to transform the labor world into a better world.

A) Nowadays practically all of us live being a part of many organizations where we participate and develop different activities, sometimes simultaneously, and we are always us, even tough we go from one to another. From birth to death we form a part of organizations and it seems natural sometimes since one point of view this is true and sometimes since another one, not so much— due to the universal tendency to gregariousness that makes the isolated or lonely individual to be an exception. It is truth that organization, education and human ability development have been the essential solution for nations' development. (Because of the topic chosen in this paper I cannot extend on education, that I do believe is fundamental for the future of a country).

This planet has become a dense web of organizations that put rhythm to life, where some traditions lighten and current postmodernism announces, in part, due to new webs' presence, that were maybe already here, but unseen, or the traditional ones evolve and get new forms up to the point to seem unprecedented.

B) With transcontinental and autochthonous cultures, since many centuries ago we certainly count on wealthy historical roots and multiple cultures of permanent active integration; however for my subject no doubt Greeks and Romans provided us with research of excellence and humanity perfection the first. And with the art of organization and the empire of the law the second. I must admit that inheritors are not always conscious of the legacy received, its development and improvement. Even they —we— have also historically failed.

C) The integration of people in an organization is ruled by the organizational structure; even though, we do not notice, as we have mentioned in previous paragraphs. However, the hierarchy is what remains in the structure, which in most cases is transferred by the common procedure beings from the strongest, the one who has the power to the submission of the weakest. In organizations we call it power; but, in my opinion, this traditional vision is only partial. Stability in an organization is given thanks to a hierarchic structure that has become civilized through centuries, taking out aggressive conducts of the "strong" or "machos" in delicate schemes of the same dominium power. The organization has created social structural spaces where struggle can be divergent or bivalent. The last one is a struggle among people in superior – inferior – superior and lateral hierarchic levels. At the same time aggressiveness and will of power is determined in achieving certain objectives. The divergent is divided in: i) Hierarchic levels argue and fight among them like persons and the objectives and goals are forgotten or put in contrary. ii) Or they dedicate effort, aggressiveness and will of power and joint together to achieve objectives and reach goals. They do not fight against no one in particular.

D) Cooperation is the solution to this dilemma and it is given when two or more individuals get the responsibility to reach the goals they have in common and that they know no one could fulfill by him or herself alone. Their objective is common and so accepted by each one. They joint knowledge, abilities and skills to serve the team and each one does his/her part of the job. They coordinate efforts to help and support each other according to their time and talent. The most important ingredient in this cooperative is related: consciously accepted the interaction. For cooperation inside any organization knowledge, abilities and skills are not as important as acceptation and understanding to the others, which includes emotional intelligence focused on positive attitudes toward the other members of the team, to prevent arrogance and even get a dose of good mood.

E) Energy can then be concentrated, a truly synergy from the design and planning, from changing ideas with no false modesty; no comments, gestures or actions that can make somebody uncomfortably or upset. Go through operation and implementation of common actions, socialize actively your knowledge, skills and abilities or talent of your own working field to help the team get the objectives which have been set and decided by all members. If you can reach the cooperation level all efforts will be prized: the same structure, hierarchy and even the organizational visible elements usually seem to disappear, and what come forth is a group of people interested in affective and active relationships not only to each other among them, but with the whole organization. As it is commonly said "they will feel a part of the great family". They have grown up (out) to the compromise. It seems to me that the best symptom of a well working organizational structure is to be out of sight. I think that in the human body when you are healthy you don't feel your skeleton, muscles or nerves. But get ill and you see!

F) When I was younger and sports amateur I discovered that great figures in collective sports like soccer football, basketball, baseball, volleyball and so on, there always were the arrogant "stars" and you had to treat them with "gloves" so they could leave individualism apart and play with and for the team. When I took care of a soccer football team in the school where I used to work in Mexico City, I decided to choose players with not so many abilities but with a positive attitude towards the team and me, and not the supposed crack. I worked integrating them as a team who plays to have fun and win with no doubt of their effectiveness. They were so enthusiastic that we finished unbeatable champions in the Football League to which we were members. I learned what "wearing the shirt, the cap" means! And since then I have put it in practice with fruitful results every time I was the boss.

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End Notes

1 The experience we have in Mexico about bureaucracy and bureaucratization is not pleasant at all. The corruption and inefficacy we have carried with them along the last decades are very unfortunate, up to a point that is despicable. However, Max Weber (1864 – 1920) considered at his time that bureaucracy was the prevailing organization in society due to its efficiency understanding it as the formal organizational structure with rules, based in job specialization, with a hierarchic authority, rigid promotions and selective nominations. If this characteristics were fulfilled we would really had another image that would be a paradigmatic ideal.

2 PYMES : Pequeñas y medianas empresas, in Spanish ; i.e.: Small & middle enterprises

3 In Public Administration decentralized is understood as the transference of a part of the authority & power from the Supreme Government of the State into various corporations or offices, providing them with jurisdictional personality and the logic resources for those duties. Sometimes those offices are outside of México City, sometimes that transference is given to the governments of the 32 mexican states level or to municipalities. On the other hand, the desconcentración —in Spanish—, may be translated by spreading or dispersing parts of the Federal State administration, making space or distance from the Federal District where the Federal Government seats, due to pragmatic reasons, but the Government keeps centralized the personality and power of the authority.

The State of Human Resources in the Slovak Republic Police Corps in the Light of Research Results

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Abstract

There are still many problems in the transitional economies in central Europe shifting from previous communist regime – especially also in human resource management area. This study deals with the human resources in the Slovak Republic Police Corps. The focus of the research is on the present state of the Slovak Republic Police Corps. In addition, the future expectations of the policemen in Slovak Republic have received a great deal of attention. The analysis is based on relative number analysis and correlation analysis of empirical data. The results of the analysis have crucial implications regarding fluctuations and labor turnover in the Slovak Republic Police Corps. The expectation is that the research results from this study would help initiate changes in the area of human resource management and improve the performance of the human resource management activities in Slovak police corps as well as in related areas.

The importance of human resources management in police corps is evident in the present times. Transitional processes in eastern and middle Europe following the shift from previous communist regime to democracy have special implications in human resources in public sector, especially in police corps.

The human resources management in police corps has several goals, one of the most important and final goal is to improve the quality of a public service – police service. For example G. A. Cole (1997) presents more detailed view on personnel policies and improving factors in organization [1].

Many specialists (for example Edward E. Lawner, 1999) emphasize, that involvement or commitment – oriented approaches to design and management of organizations are an increasingly popular solution to the motivation and performance challenges faced by today's companies. The advantages of the involvement approach are said to include higher quality of services; increased job satisfaction and motivation; less absenteeism, and staff turnover; better decision making; improved problem solving and decreased management overheads [2].

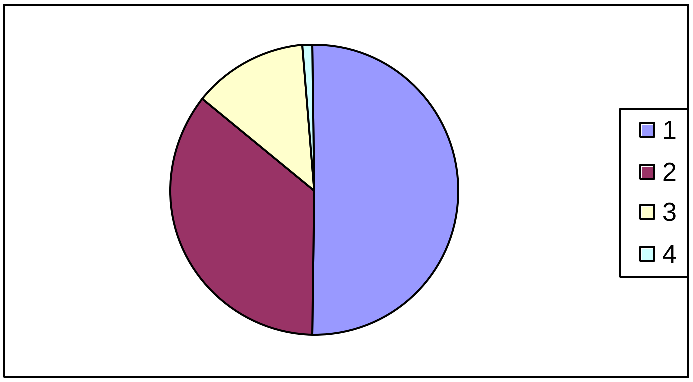
To improve the quality of human resources we must research the present state in that area.

The main aim of the study was to make an analysis of the current situation in the Slovak Republic constabulary and its perspectives in view of its members. The dates of research were November 2002 through January 2003.

We did research on members of the Slovak Republic constabulary with 3 districts selected by random selection from the Slovak Republic districts. Data collection methods included designing of questionnaire. A variety of question types, e.g., scale-type questions, closed, semi-open, open questions were used in the questionnaire. Processing methods were based on relative number analysis and correlation analysis.

1. Sample Structure

The poll was focused on the SR constabulary members in the districts of Poprad and Stará Lubovna, and Prešov. The anonymous questionnaire used for data collection included 27 questions. The first three of them were of the classificatory type. Questions 4 – 27 pertained directly to the research. The number of respondents was 422. The questionnaire return rate amounted to about 95%.
The respondent structure by age was as reflected in Fig.1.



1 20-30 years of age
2 31 – 40 years of age
3 41 – 50 years of age
4 51 – 65 years of age

FIG. 1: THE RESPONDENT STRUCTURE BY AGE.

Following table Tab.1 shows some details of researched sample, received answers, proportions etc. The respondent structure by service period is shown in the Tab. 2. The respondent structure by service type is included in table Tab.3.

TAB. 1: THE RESPONDENT STRUCTURE BY AGE

The respondent structure by age				
Age	20-30 years	31 – 40 years	41 – 50 years	51 – 65 years
Answers received	204	147	53	18
Total number	422	422	422	422
%	48,3	34,8	12,5	4,3

TAB. 2: THE RESPONDENT STRUCTURE BY SERVICE PERIOD WAS AS FOLLOWS:

The respondent structure by service period				
Service period	up to 6 years of service	up to 15 years of service	up to 25 years of service	more then 25 years of service
Answers received	123	198	63	38
Total number	422	422	422	422
%	29,1	46,9	14,9	9,0

TAB. 3: THE RESPONDENT STRUCTURE BY SERVICE TYPE WAS AS FOLLOWS:

The respondent structure by service type				
Service type	public order police	criminal police	traffic police	other
Answers received	272	59	37	54
Total number	422	422	422	422
%	64,4	14,0	8,8	12,8

II. Evaluation of the answers

The relative number analysis enabled us to draw the following highly interesting conclusions:
The first research question, i.e., the forth questionnaire question **"To what degree have your reasons for joining the SR constabulary been confirmed in the actual service?"** was answered as "definitely yes" and "rather yes" by 78% respondents in total, which indicates the prevalence of positive answers.

As for the question examining three main reasons for joining the constabulary, the highest relative numbers were obtained for the following answers: **"opportunity to work with people"** (42.4%), "diversity of activities" (38.6%), and "social significance (importance) of this job" (35.3%).

An important research output was obtained by **correlation analysis** zeroed in on the possible correlation between the answers to questions 4 and 25, i.e. the questions of the following type:

"You have been with the constabulary for quite a long time now. Hence, can you assess the extent to which the main reasons for joining the constabulary have been confirmed in your actual service?" The following answers were offered as options: 1. Definitely yes, 2. rather yes, 3. rather no, 4. definitely no, 5. I can't assess it. The question **"If you were to take a decision now, would you become a policeman again?"** could be answered as follows: 1. definitely yes, 2. rather yes, 3. rather no, 4. definitely no, 5. I can't assess it.

Importantly, there is a correlation between the answers examined, with the calculated correlation coefficient for the whole sample being $r = 0.312$. By implication, there is a significant interrelation between the confirmed reasons for joining the SR constabulary, on the one hand, and the respondents' preference of the constabulary in the case of a repeated decision-making process.

The highest relative number of respondents answered the question **"Are there any opportunities for and are you interested in further education"** with "yes, there are opportunities and I am interested in further university education" (37.2%), officers' college (22.2%), and "university education for policemen".

The question concerning **working conditions and the superordination/subordination** (question 8) was chiefly answered as "I find the job interesting" (54.9%), "my superordinate is up to the managing position" (47.3%), and "I find my work important and useful" (37.9 %).

Question 9 is based on **four significance levels in the individual areas**. Better working conditions, higher social certainty of this occupation – improved human resource strategy and better financial stimulation were of **great significance**. More attractive job content, better moral stimulation, and improved free-time conditions were viewed as **partially significant**. Better free-time conditions, clarification of the meaning of police activities and of social significance of their work, and more attractive work content fall within the category of **low significance**. **No significance** was attributed to improved free-time conditions, higher attractiveness of police work content, and improved health-security and recreation opportunities for policemen and their families.

The ranking of **the most important police staff performance-supporting factors** is the following: 1. possibility to spend one's time with his/her family, 2. financial remuneration, 3. human relations. In addition, the following factors affect the performance in a positive way: insisting on responsibility for one's work, 2. satisfying work, 3. the need to be beneficial to the society. The following factors have no effects: 1. promotion in one's rank, 2. opportunity to exercise powers, 3. promotion in one's position. Rather negative effects upon the performance were attributed to 1. Appreciation of one's work, 2. Opportunity to exercise powers, in combination with the income, 3. Financial remuneration. Negative effects were attributed to 1. Appreciation of one's work, 2. Management quality, 3. Opportunity to exercise powers.

The largest number of the respondents answered question 11 inquiring about the respondents' satisfaction with their working conditions as follows 1. neither satisfied nor unsatisfied, 2. rather satisfied, 3. very unsatisfied.

III. Correlation analysis

Another significant issue concerned the correlation between the answers to question 11 and question 15, i.e., the question of the following type: **"How are you satisfied with your working conditions?"** The range of possible answers was as follows: 1. very satisfied, 2. rather satisfied, 3. neither satisfied nor unsatisfied, 4. rather unsatisfied,

5. very unsatisfied. The options for the question **“How are you satisfied with your current income”** included 1. Very satisfied, 2. Rather satisfied, 3. Somewhat satisfied 4. Rather unsatisfied, 5. Very unsatisfied.

The correlation analysis has confirmed the correlation between the answers to the two above mentioned questions, with the calculated correlation coefficient for the whole sample **r = 0.424162**. It implies significant interrelation between the degree of satisfaction with working conditions in the SR constabulary and the degree of satisfaction with incomes at the SR constabulary.

IV. The Other Results of the Analysis

The ranking of the answers to question 12 **“What should be improved in your working conditions in your view?”** was as follows: 1. More effective powers and better legislative measures, 2. Material, technical, and social conditions – equipment (computers, accoutrement, transmitter, car, fuel), 3. Financial, moral appreciation from the superordinate, 4. Improved working conditions – building renovation, purchase of new furniture (cabinets, chairs), 5. Human resources – the most important aspects:

- human relations, superordinate vs. subordinate
- improved organization
- relations to other constabularies, especially to their staff
- improved social and security conditions for the employees and their families
- improved information flow
- changes in the system of work
- improved management and command quality
- elimination of senseless commands
- possibility to work with people
- more relaxation (more sleep)
- boarding conditions
- inspection
- more time for paperwork
- self-realization
- economic sufficiency
- loyalty, team spirit
- elimination of fluctuation

6. reduced red tape
7. increased income
8. higher qualification
9. improved morale – also in respect of the citizens
10. reduced corruption
11. better training, i.e., its professional level, further education, and participation in educational courses
12. increased staff number
13. the diagram does not indicate the cancellation of the bar-code as Point 13. It represents 3.3% of all respondents.

The majority of respondents answered the question concerning the improvement of working conditions as follows: 1. Material, technical, and social conditions – equipment (computers, accoutrement, transmitter, car, fuel), 2. Human resources, 3. Increased income.

Question 13 concerning **“the degree of coping with the conditions of life (as a policeman)”** yielded the following answers: 1. I got used to them and have no problems in coping with them, 2. They cause me difficulties, however, I can cope with them, 3. I do not find the conditions to be difficult.

Question 14 **“To what extent can the situation in the individual constabulary areas be improved?”** was answered as follows: 1. material and technical working condition, 2. available powers, 3. unbiased assessment of the constabulary work by the mass media. The “**partial improvement**” option was answered as follows: 1. my professional ability, 2. human relations, 3. the level and efficiency of meetings. The answers within the category of **“No improvements required”** were as follows: 1. Service discipline standards and rules, relations between older and younger employees, the contemporary policeman uniforms.

The answers to **“How are you satisfied with your income”** were ranked as follows: 1. middling satisfied, 2. highly unsatis fied, 3. rather satisfied.

The answers to **“How do you imagine your future in the constabulary”** were ranked as follows: 1. I wish to stay at the constabulary, 2. I wish to stay at the constabulary, however, in a different kind of service, 3. I have not considered this issue yet.

The answers to **“What do you find inconvenient in your work”** were ranked in the individual categories as follows:

Most inconvenient: 1. paperwork, 2. psychical stress, 3. meetings.

Partly inconvenient: 1. meetings, 2. risking one’s health and life, 3. legal responsibility for the police actions.

No objections: 1. field work, 2. physical demands, 3. Operating computers.

The degree of satisfaction **“with the material and technical conditions”**:

Very satisfied: 1. uniform as a means of representation in public, 2. computer technology, 3. accoutrements with regard to weather conditions.

Rather satisfied: 1. uniform as a means of representation in public, 2. accoutrements with regard to weather conditions, 3. hygiene and sanitary facilities.

Somewhat satisfied: 1. uniform as ameans of representation in public, 2. accoutrements with regard to weather conditions, 3. hygiene and sanitary facilities.

Rather unsatisfied: 1. accoutrements with regard to weather conditions, 2. vehicles, 3. technical facilities.

Very unsatisfied: 1. vehicles, 2. technical facilities, 3. computer technology.

The answers to question 19 **“Realistic career perspectives”** were ranked in the individual categories as follows:

Yes: 1. promotion in rank, 2. promotion in one’s position, 3. transfer to a financially more attractive job.

Rather Yes: 1. promotion in rank, 2. promotion in one’s position, 3. transfer to a financially more attractive job.

Rather No: 1. transfer to a more attractive kind of service, 2. transfer to a financially more attractive job, 3. promotion to a higher service position.

No: 1. promotion to a higher service position, 2. transfer to a more attractive kind of service, 3. transfer to a more attractive kind of service.

I do not know: 1. transfer to amore attractive kind of service, 2. promotion to a higher service position, 3. transfer to a financially more attractive job.

The most frequent answers to **“What is your view of your future career as apoliceman?”** were the following: 1. I wish to stay with the constabulary as long as I feel I am useful, 2. I wish to stay with the constabulary until the end of my productive age, 3. I can leave the constabulary depending on the circumstances, however, no sooner than I can claim the pension.

The respondents are mo st frequently 1. Rather satisfied, 2. Rather unsatisfied, 3. Very unsatisfied with their respective **service position**.

Question 22 **“What is the development of your social status?”** was most frequently answered as follows: 1. negative 2. Unchanged, 3. Positive.

Question 23 **“Have you experienced any negative citizens’ attitudes to the constabulary?”** was most frequently answered as follows: 1. Yes, quite frequently, 2. Yes, exceptionally, 3. Yes, permanently.

Question 24, **“How do you perceive the negative attitudes of the public to the constabulary?”** was most frequently answered as follows: 1. I do not care, 2. It hurts me, however, I can cope with it, 3. I am disgusted at it and can hardly cope with it.

The question **“If you were to take adecision now, would you become apoliceman again?”** was most frequently answered as follows: 1. rather yes, 2. rather no, 3. definitely yes.

Question 26 **"Are you satisfied with your professional career?"** was most frequently answered as follows: 1. middling satisfied, 2. rather satisfied, 3. rather unsatisfied.

The following answers occurred for the open question (27) "**In your own words, express the facts pertaining to your professional career at the constabulary which were not covered by this questionnaire and which you find highly important!"**:

1. no promotion chances
2. lack of appreciation
3. corruption – favouritism
4. useless red tape
5. assessment by citizens
6. technical facilities
7. legislation and powers
8. human resources
9. better financial remuneration
10. education opportunities
11. improved discipline and observing the laws also by the constabulary
12. improved working conditions
13. decisions of the superordinate contradicting the law
14. changes in the job position tables
15. the questionnaire is inappropriate
16. nothing can be added, no comments
17. the questionnaire will not result in any changes
18. unsatisfied with one's work at the constabulary
19. a larger number of policemen with university education needed
20. the respondent agrees with the questions
21. the respondent does not agree with the questions
22. increased number of policemen.

The most frequent answers included: 1. human resources, 2. nothing can be added, no comments, 3. better financial remuneration.

The most important factors in the field of human resources include:

- human relations, superordinate vs. subordinate
- better organization
- relations to other constabularies, especially to their staff
- improved social and security conditions for the employees and their families
- improved information flow
- changes in the system of work
- improved management and command quality
- elimination of senseless commands
- possibility to work with people
- more relaxation (sleep)
- boarding conditions
- inspection
- more time for paperwork
- self-realization
- economic sufficiency
- loyalty, team spirit
- elimination of fluctuation

In conclusion, we hope the measures reflecting the research results will be implemented in the shortest possible time.

There are personnel policies, which can contribute to change the situation in human resources also in such organization as police corps [3].

Human resource managers in Slovak police must use all motivational tools for maximizing work satisfaction of policemen. As the research showed - there are many barriers and remnants from previous regime [4]. Many traditional values in Slovak police were destroyed. But the improvement in that area is necessary and it is upon us to bring in these improvements. This indeed is the aim of the Slovak personnel managers in police corps.

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Mexico: The Challenges of Human Development

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Abstract

We offer here the vision of development not only as economic growth and income redistribution (conceived both in a simultaneous way) but through the concept of Human Development, elaborated by the United Nations Organization (UNO) in some official documents. With data of the UNO, an application of the Index of Human Development (IDH) is done to the situation of Mexico, keeping in mind the growth of the GDP, the income average per capita, the elements of health and education, the democratic component and the indispensable vision of the culture.

Introduction

In many social essays of the twentieth century, the efforts of development have concentrated on the promotion of growth and economic expansion, elevating the quantitative levels of the Gross Development Product (GDP) of the countries and subsequently the possibilities of greater incomes for the population. This happened even in the approaches of the UNO. Nevertheless, in real, it has been verified that the increment of the national product per capita does not produce automatically a greater welfare of the persons; although it is an important element for the prosperity in a single country but is not the only one.

In the specific case of Mexico, we know that the country is the ninth economy of the world in September of the 2002, focusing only the GDP, but in the Human Development concept of the UNO, we appear in the place number 54 (IDH-ONU. Newspaper Público, August 8, 2002). In many cases, the growth occurs but causing a bad distribution of the benefits, increasing tremendously the differences among few people who are wealthy and many who are poor.

In this text, we know the importance of the economic growth and stability but with other characteristics in the same significance, if we want to visualize a true development for Mexico in the future. It is not good to seek first the economic growth and then expect as necessary consequence the distribution of the wealth; we can reduce development neither to the economic growth neither to the income per capita, but we should get other determinant elements of the human life as health, education, citizen participation in democratic institutions and even the culture. We offer a more suggestive approach when we formulate that the development is an effect of a democratic political system, and therefore we center our attention in some fundamental ingredients of such system.

1. Growth tendencies in Mexico

After the serious crisis in Mexico in 1994-95, the country has been experiencing stable indices of growth in the macroeconomic figures, in spite of certain moments of deceleration as it was in 2001 and 2002, when the north-American recession dragged us to an almost scarce growth during those years.

According to the numbers of the INEGI, the GDP (nominal value) gotten at the end of 2001, was 627 billion dollars; there was 558.962 billion dollars during the year 2000; it signified a growth of 12.17% from one year to another. Continuing with the math, it meant that the annual income average by Mexican inhabitant reached the figure of 6,119 dollars, in spite of the fall of the economy during the 2001. It must be emphasized the ascending rhythm of the annual income average that had been of 4,904 dollars in 1999, and 5,831 dollars in 2000.

We can keep in mind also the emphasis in controlling inflation, because we recall the year 1987 when we had the highest rate of inflation in our history (154%) and also the tremendous crisis of 1995 with an elevation of prices near 100%. In this sense, if we are arriving at the rate of 5% of inflation in Mexico, it has to be considered like an appropriate condition of stability for the course of the country.

With these objective data and the tendency in the evolution of production and the markets toward the next 25 years in the XXIth century, the specialists have indicated that in the international framework, in agreement with the volume of its production, the most important countries will be China (with the 26% of the GDP in theworld), United States (with the 21%), the European Union (with the 20%), India and Japan (with the 13%), Brazil and Mexico (with the 7.3% of the GDP world). (Cfr. Aguilar Ruben, Newspaper El Universal, 2002).

At present, by the size of its production, Mexico is the ninth economy of the world; the World Bank thus has recognized it, and the President Fox has expressed it in its second report of government. As empirical data, it cannot be contradicted, and one must take into account as somewhat outstanding, although, as we maintain, it cannot be the determinant element in the development problems.

Still it exists and is found in governmental officials documents the paradigm of the development based only in the economic growth: it is supposed that all the social energy should be promoted to produce a cake increasingly bigger; there is no case giving importance to the redistribution of wealth if we do not have growth, because it means to redistribute the misery; all the investments should be productive in order to increase the wealth of the nation; in a natural process and in a long time of time, we will get slowly but firmly the benefits for all the population, first with the crumbs falling from the table and later with the participation of all in the national wealth.

So much the World Bank (BM) as the International Monetary Fund (IMF) they utilized for a great deal of time only the monetary and economic indicators to measure the development. Nevertheless, nobody can show the direct relation between the economic growth and the distribution; the two strategies should be presented as indispensable in a simultaneous way if we call it development. Because of it, we have to advance toward a second definition of the concept: growth with distribution, where the defenders of this position "adopt the principle that the just distribution –the abolition of the massive poverty and of the large inequalities concerning wealth- cannot be derived from processes of falling crumbs neither of politics of charity. They maintain that so much the equity as the growth should be planned like direct goals of the strategy of development" (Goulet and Kwan, 1989: 35-6).

2. Some contradictions

All we can be surprised about the power of the Mexican economy based on the previous figures when we observe problems of poverty, technological dependence, bad urban infrastructure, crisis in the rural production, etc. It carries us, in the first place, to redefine in a radical way the concept of development, not reducing it only to the quantity of the national GDP.

The first element call our attention is that, in the same levels of mathematics, when we consider the income average by inhabitant in Mexico (6,119 annual dollars at the end of 2001), the rank of the country falls –being the ninth world economy with respect to the GDP- we are placed in number 29. This is because the GDP in each country is divided among the number of inhabitants; the is the income average; therefore, depending on the inhabitants of each country in relation to the GDP, the rank varies.

The highest GDP per capita in the contemporary world is found in Norway: 36,219 annual dollars; later come the United States, Swiss and Japan. In the case of Mexico, is interesting to analyze the comparison with its associates in the North American Free Trade Agreement (NAFTA) : United States has an 35,835 dollars annual income average by inhabitant while Canada has 22,572. One must celebrate that Mexico has now that GDP per capita annual of 6,119 dollars, but the distance with its associates is from one to four with Canada and from one to six with the United States.

As it can be seen, the income average per capita express a great deal more than only the quantitative data of the GDP; but, even so, that theoretical distribution of the wealth among the number of inhabitants continues hiding the factual reality of how is distributed the income and how the social benefits are distributed. In order to distribute, it is necessary to grow, but we have to stand out that the alone quantitative growth does not produce distribution of the social wealth; it can exist an intense dynamics of growth and simultaneously a great dynamics of concentration of the income.

One of the contradictions that more is calling our attention is the contrast among the wealth of a country (by its GDP, or by the income average per capita) and the empirical reality of the badly distribution of the income. It is a fact recognized in many regions of the world, as the World Bank says: "in Latin America, Asia and Africa at the south of the Sahara, the poor number of persons has not left to enlarge" (World Bank, 2001: 3). This reality in large levels of poverty exists vis a vis groups that concentrate the wealth, and carries us to abandon the conception of a development based exclusively in the economic growth; the most solid contemporary theories carry us to conceive growth and distribution of the social wealth as two necessary faces in the development; still now, some analysis offer the theory of the "leak": first it is necessary to grow and, after that, late or early the fall of crumbs will come to the people in the redistribution of wealth. We maintain that the development implies necessary and simultaneously politics of growth and politics of distribution, if we consider the most minimum social approach of justice.

In Mexico, numerous debates on the size of the poverty have been existed; but is indisputable its existence. Though, on this point one must continue analyzing and debating, we can take the last agreement of the Mexican government of Vicente Fox, on August 2002, with other analysts in the academic world and from the private enterprise, distinguishing three levels of poverty: they arrived at the conclusion that in Mexico 23 million inhabitants are in an extreme situation; we had 32 millions if we take the medium situation of poverty; and finally they were recognized 53 million Mexicans (including the two previous levels) that suffer the "poverty of patrimony" (persons without sufficient incomes to satisfy the daily needs of food, dress, footwear, dwelling, health, public transportation, education. ..). If this is so, then, in the year 2000, more than half the population had some level of poverty in Mexico. Subsequently, in an interview televised in CNI, the secretary Josefina Vázquez affirmed that, in the best of the cases, the Mexican government would be able to aspire, at the end of its six-year period, to diminish from 53 to 44 the millions of poor people in the country.

This situation must be seen vis a vis the level of concentration of wealth; we are going to show one example based on the data of the American magazine Forbes. This magazine, year with year, brings to light data on the richest men of the world, brought to light at the beginning of the 2002: on 2001, 12 Mexicans were in the list of the called super rich, those persons whose fortune elevates at more than one billion dollars. The businessman Carlos Slim, owner of Telephones of Mexico (TELMEX), was maintained like the richest man in Mexico and Latin America with a fortune of 11.5 billion dollars, placed in the rank 17 of the wealthiest men of all the planet. Some other Mexicans inside the same category are the following: Jerónimo Arango (shareholder of Wal Mart, with 3,7 billion dollars), Lorenzo Zambrano (of Cemex, with 2.8 billion dollars), Eugenio Heron Laguerea (2.3 billion dollars), Roberto Hernández (1.8 billion dollars), Alfredo Harp Helú (1.3 billion dollars), etc.

In all the societies in history there has been this division between poor and rich, but in the contemporary world with modernization, industrialization and globalization, what aggravates and makes more scandalous the situation is this unjust and close contact between those who have big money and too much wealth and all those that do not have the indispensable thing to live and scarcely survive, constituting a more extensive world of poverty and extreme poverty.

3. The human development concept

If the development himself is not reduced only to economic growth, many would be able to think that the complement of the distribution of wealth would fill then, in a complete way, the definition of the concept. But we have to advance to a third definition that we are adopting in this article: for the people, the benefits of the growth are determined so much by its quality as by its quantity, by productive and distributive aspects. Some of the most frequent human aspirations are to enjoy a healthy and long life, to get the suitable knowledge to get by in a successful way and to assure an encouraging and worthy conditions of life for the family. Of the same way, the human being seeks to be free to elect among several options; to participate actively in the public life; to transmit to their children a sufficient capital of resources; to develop his personality, initiative and responsibility to be an actor that determines the course of his existence in an environment of liberty and justice.

"The priority task of the development no longer consists of achieving the maximum or the optimum total growth but in satisfying a basic assembly of needs.. This assembly of needs includes goods and services relating to the nutrition, health, dwelling, education and employment.. The Basic Human model of Needs incorporates two elements more in its recommendations: emphasis in the self-sufficiency, local and national, and preference for the solution of problems with a style that permits the participation" (Goulet and Kwan, 1989: 37). Nutrition, health, reproduction, education, cultural identity, political liberty, social participation, institutional efficiency and environmental quality are important ingredients of the quality of life, that are shown in the capacity of the persons to live in a way that more esteem. For the execution of these yearnings it is a central, but not exclusive element, the disposition of a stable and sufficient income.

From this perspective, the human development places the persons, with their needs and legitimate expectations, in the center of the efforts of the development. It would be able to formulate a universal objective: to promote the capacities of all the human beings so that they have the opportunity to enjoy the type of life that more value, multiply their capacity and to be able to direct responsibly their existence; but the development, then, would have to see with other elements that have to see also with the politics and the culture.

According to various documents of the United Nations, the new human concept of development implies the following things:

- A basic demand of equity, banishing the discrimination.
- The ingredient of the sustainability, understood like the extension of the notion of equity applied to the next generations.
- The creation of capacities and opportunities for the population, intimately connected with institutional elements that would facilitate them; because of it, the conquest of a greater general welfare is associate to the construction of a democratic political framework of institutions that encourage the citizen participation.

This human vision of the development is not limited to the economic aspects, but it extends to the environmental, political, cultural, and social spheres. The economic growth continues to be an indispensable element; one must complete it with an effective social politics to eradicate the poverty; it has to be complemented with the upper goal of a harmonic welfare general, certain levels of citizen participation and a respectful use of the natural resources, thinking in the future generations. Since 1990, the Program of the United Nations for the Development (PNUD) publishes annually a world Report (Report on Human Development) that analyzes different dimensions of the problem, from the perspective of the human development. These documents have been offering a new globalized framework very suggestive that always one must keep in mind when we speak on the processes of the development in the different countries: the major success was the incorporation of social dimensions of the poverty, trying to measure and to compare the development among the nations, mainly taking into account the life hope indicators, alphabetization, employment and income per capita.

Understanding the human development as an enlargement process of opportunities for all the persons, we begin with the recognition that it is in the framework of the options created by the society that the persons can enjoy the opportunities offered and can face the risks of life in better conditions. The human concept of development covers multiple dimensions of the life of the persons and of the social groups: family, social, environmental, economic and political.

A true development cannot sacrifice the persons or their natural environment in the search of the economic growth. If this growth is not translated in the broad satisfaction of the needs of the people and in the respect of their natural environment, any success will be of a meager duration; the increase of the general welfare and the conservation of the environmental potential constitute indispensable structural conditions to maintain the economic progress.

Defining the persons as the basic objective of the processes of development and centering the attention in the needs, hopes, capacities and options of the people, the human development covers an extensive fan of the human aspirations. These are not reduced to the alone economic availability of resources, but include a great diversity of benefits, so much materials as intangible, that contribute to welfare and happiness. The options valued by the people differ according to the historic context and vary through the years, arriving even to be unlimited. Therefore, with some basic and general considerations on the human development, we can say that there are three essential capacities; without them, nobody count on many options to satisfy other aspirations. Thus, a way to measure the human level of development of a population can be given based on the following three capacities:

1) The longevity as the experience of a healthy and long life.
2) The educational achievement as the capacity to acquire the suitable knowledge.
3) A standard of living in which people can get the necessary resources to live their existence.

This implies some programs in diverse areas: an effort focused to improve the social conditions of the poorest; prevention of the avoidable deaths; the programs of reduction of the illiteracy; to seek a greater incorporation of children, girls, adolescents and young to educational system; to assure that the growth gives benefits to all the population. For it, also it is basic to count on a healthy people, distributed in adequate way in the territory, so that the population imbalances, in one or another geographical zone, do not signify environmental risks for their inhabitants.

Trying to do a synthesis, it would be able to say that the Human Development can be structured in the following axes of action:

1) Equity: translate the economic growth in general welfare
2) The educational framework: creation and extension of the adequate knowledge in the population
3) Competitiveness: capacity to maintain and to enlarge the participation in the markets, elevating at the same time the standard of living of the population.
4) Sustainability: the enjoyment of the land and the social wealth produced should be planned to be extended to the future generations.
5) Governability: growing political participation of the citizens in the democratic framework of institutions.

"Human Development is that process by which the person is done subject and effective beneficiary of the changes under way. According to the World report of the PNUD, it signifies an environment in which the persons can do fully reality their possibilities and to live in creative and productive way according to their needs and interests. A precision: the Human Development opens a perspective, this is, does not imply some model of development but a way to focus the social life" (UNO, 2002: 16).

4. The democratic component of the development.

An element to which it has not been given the proper importance in the processing of the development is the construction of the democracy and the state of law. The underdevelopment does not only consist in a poverty situation, understood like economic lack of resources; as it recognizes the World Bank the "poverty is also vulnerability and incapacity to be heard, and lack of representation" (World Bank, 2001: 23). The consolidation, therefore, of a democratic political order, with an active participation of the citizens, is also integral part of the human development. In such sense, the construction of a participative democracy and a state of law in Mexico presents advances in some fields, but also shows a situation still very fragile.

The political modernization especially in the democratic constitution of our societies has two essential aspects: first, the vote and the electoral systems, that should guarantee each time the better emission of the votes and the final results so that the population can count on authorities fully legitimized by the majority of the population; second, the citizen participation beyond the electoral moments in order to influence constantly in the elaboration and execution of the public decisions, what implies a constant organization of the citizens in multiple interests without depending necessarily in the protection of the State.

This vision of the human development is essential in order to get a social climate of greater security and confidence for all the persons, what signifies the construction of a democratic political order with participation of the citizenship in the management and public decisions. In this manner the sense of commitment will grow because the know that they belong to the society in which they live.

In Latin America, since the decade of the 1980s, we lived a process of removal of the dictatorial and authoritarian states governed by the military; in these decades, at the end of the XXth century, the continent has been seen covered with civil governments arisen from electoral processes. The Summits of the Americas (Miami 1994, Santiago of Chile 1998, Quebec 2001) have come to say, under the initiative of Washington, that the whole continent is "democratic", with the exception of Cuba, the only country not been invited to such summits. Under this vision, it seems then that the democratic development has arrived to Latin America, keeping in mind the only criterion of electoral execution of processes, taking aside other important elements of the analysis.

For Mexico, that did not suffer that Latin-American type of dictatorships of military type, the analysis of democratic transition has also applied recently, due to the political alternation in the Republic presidency, on july 2000, after many decades of domination of a one political party, the Institutional Revolutionary Party (PRI), in the national life. The now president Vicente Fox, of the ruler National Action Party (PAN), has come to affirm that Mexico passed already the phase of transition and has entered to the consolidation of its democracy since the presidential change in 2000.

But this analysis of the Mexican democracy is not wise. The governments of the PRI were not democratic, even in the unique environment of the electoral processes; there was the weakness of the laws in this matter and the constant practice of fraud lived in numerous moments of the political life. If we reduce democracy to the electoral processes, then the democratic transition has finished; but if democracy, as Alain Touraine says, we define it like an inner process where exists the respect to the fundamental rights (including the respect of vote, as one of many), where the representation of interests in the political system exists and where it has been institutionalized the citizen participation processes, then the transition has not concluded in the moment when it begins to exist the credible and more legitimate elections. "A great diversity of states exists whose action respects one alone of these principles destroying the other two. None of these states can be called democratic, as can neither be those ones that do not do more than organizing some relatively open elections" (Touraine, 1994: 353).

Mexico had a significant period of economic growth since the years of 1940s until the end of the decade of 1960, a phase that officially was called "a stabilizing development" and that people knew like the period of the "Mexican miracle"; the most important criterion to speak of the development in Mexico in that moment was the continued economic growth of GDP in an annual average of 6%; the salaries of many people grew up; it was maintained the stability of change between the Mexican peso and the dollar. But the time itself destroyed the illusion of the Mexican industrial development: the crisis of 1976, 1981, 1987 and that of 1994 were a painful show of the weak of the word development. But those same crisis were accompanied by the called process of transition to the democracy with a strong citizen participation, that has had a significant moment in the political alternation in the presidency in the year 2000. These advances in the transition process are the same that give us the possibility to impact now directly in the economic development because we know that democracy is directly associated with the human development. In the United Nations, Mark Malloc, the administrative general of the PNUD, speaking about the human development, he has said: "the politics is as important as the economy" (Newspaper Publico, 8 August 2002). In a radical way, we would be able to say that "the development is not the cause, is the consequence of the democracy" (Touraine, 1994: 335); this means that only a strategy discussed and approved between the government and the citizens organizations, making a pact among all the political forces can carry to surpass the previous phases of the development in the country.

This last position permits us to surpass with clarity the old formulations of the development linked only to the economic growth, and even those that consider the growth linked to the distribution of the wealth. The human development that we seek has certainly an economic component (growth and distribution) but is necessary to emphasize the social ingredient in health, education, dwelling, etc. And with it, it is necessary to emphasize also the aforesaid political cultural dimension in democratic institutions that permits to take the social forces to a pact cooked by a consensus relating to the strategies for development. This last it is what the United Nations keep in mind when speak of the good governance as key for the development.

5. The cultural dimension

During the XXth century, particularly for Latin America, through the CEPAL, it has been insisted about the underdevelopment only like an economic problem of delay situated in the under level of the productive forces of specific countries. Subsequently, the theory of the Dependence insisted in the political fight of coordination among the nations of the to world periphery to improve the commercial exchange levels with the metropolitan countries. The governments of the industrialized nations, at the end of the XXth century, have come to incorporate a democratic clause (although at times understood only as electoral processes) as indispensable element in the programs of development. But the UNO, in the transition to the XXIth century, has begun to emphasize a new component that had not been given the proper importance: "The human development contains necessarily a concern for the culture –the way in which persons decide to live together-, because the social sensation of cohesion based on the culture and in the shared values and beliefs is what expresses the individual human development. If the people live well together, if people cooperate in a way that become mutually enriched, they expand their individual options. In this way, the human development concerns not only for the people as individuals, but besides for the way in which they interact and cooperate in the communities" (UNO, 2002: 17, citing a document of the PNUD, 1996).

The PNUD study on the Human Development in Chile 2002 is an extremely interesting example in relation to the role of the culture in our contemporary societies. The analysis is done on Chile but from the perspective of the culture; the titles of the 6 parts that integrate the report are suggestive: "The importance of the culture", "the Chilean thing: an inheritance questioned", "Changes in the cultural production: new settings, new languages", "A map of the cultural field", "The personal life of a changing society", "A diversity dissociated". The main object of the study coordinated by Norbert Lechner is "the private way in which a society experiences its contact and the way in which imagines it and represents" (UNO 2002:37).

If the Human Development is a way to focus the social life, we would be able to have a double tension: on the one hand, the possibility to universalize certain elements of the human being in the contemporary societies that make possible an empirical measurement and, on the other hand, the need to affirm that neither the goals neither the media for the development should be taken from the model of one single country; the inner force comes from the dynamism of the system of values in a specific society (traditions, locality, ...). The contradiction among universal values and local values stands out nowadays in a astonishing way when we face the diverse processes of globalization; we should say that the two levels, the global one and the localities, are interrelated constantly in all the contemporary societies.

One of those interrelation areas is the collective imagination of the social groups, where, in parallel way to the political and economic changes in the society, diverse projects stay together on what is or should be a specific country, advancing from a historic status to another. Gramsci, for example, was right when presented the importance of the ideological superstructure, conforming an educational plan as revolutionary action of the masses even when these did not be still in the control of the State, or when being the masses in the control of the State these had not reached an appropriate ideological level for the changes in the new society. In other words, we could say that the abandonment of the underdevelopment itself would not be achieved neither only with the economic changes neither with the political ones but when the population could get his collective imagination according with the real characteristics in a specific society they want.

One of the areas of the culture is the representation of the collective imaginary where the diverse social groups are situated in order to valued themselves living in their specific history. "A collective imaginary is the ideal or symbolic assembly of representations by which is defined the fundament, the motor and the sense of the living together among the members of a group or a society. The collective imaginary is not an illusion neither a fantasy. It is, on the contrary, a real phenomenon. Every society projects an image of itself and through that imaginary it is recognized like a collective group" (UNO, 2002: 38). One of the fundamental tasks of each society is to forge its own imaginary relating to the following historic situation that the people wants to build; when a consensus is created on what the main groups of a society want (that is another of the aspects of the democracy beyond the electoral processes), it is created the need of a new social pact that will make possible the political commitment for the transition. No model of development can be imposed authoritatively and, because of it, the creation of consensus and pacts around the possible imaginary of a specific transition becomes the fundamental aspect of the process. And there is the importance of the culture in the processes of development: “there are new ways of coexistence that demand new imaginary that represent them. And, in another way, there are transformations of the imaginary that motivate and orient new experiences of living together” (UNO, 2002: 38).

Gilberto Giménez, speaking about the social processes of transformation, dedicates a special focus to the “creative imagination” of the subjects and groups, considering it exactly like a motor for the social change, using the concept of “utopia” not in an alienating way but giving it the possibility of transcending the immediacy of the perception of the present, exploring the world of the possible with an innovative attitude; this is also what Ernst Bloch calls “creative hope”, when the social groups, going from the imagination provided by the present situation, agree to fight in the execution of the possible in the near future of the society.

We return now to the concept of culture given by the UNO as the way in which the society experiences its contact and the characteristics as it imagines and represents itself, and then also we return to reaffirm the centrality of the culture in the processes of development when we analyze the concrete situations that different societies live: their specific ways they want to run going from one phase to another in order to reach upper stadiums. In this sense, one of the big challenges for Mexico, after the political alternation achieved in the presidency on 2000, is to translate the advances of the democratic system in programs that affect positively the conditions of life of the population; and this itself will not be achieved but with the construction of a participative citizen culture beyond the electoral processes.

6. The measure of the human development in Mexico

Since 1990, the PNUD has carried out numerous efforts to approach the measurement of the human development, combining diverse criteria in a single indicator, the Index of Human Development (IDH).

This agenda for the human development is a great challenge, more extensive and complex than those simple instruments used to build the measurement index. Nevertheless, they permit to present specific goals in order to evaluate the impact of politics focused to establish the minimum bases on which to build a fair State, offering better conditions of welfare for all.

The contrast among different data is what explains why Mexico, with the criteria of the IDH-UNO is found in 2002 in the place number 54: “The IDH is integrated from three data: hope of life, education level and income level. The country with highest hope of life is Norway with 78.4 years. The partners of Mexico in the TLC occupy the third place in the world level: Canada with 78.0 years and the United States, in rank six, with 76.8 years. Mexico is found in the 51 place with 72.4 years. In Latin America Argentina, Uruguay, Chile and Costa Rica have a better position than Mexico. The educational level average of Mexico is 7.5 years while the U.S. and Canada passes the ten years. In Latin America, one more time, the countries already cited surpass the level Mexico has. Mexico is the ninth economy of the world, but it is the 29th in terms of the income per capita and we go down to the 54 rank, speaking about the level of human development; this does not do more than showing the contradictions and inequity of a society like Mexico, surpassed in Latin America only by the reality of Brazil that results still more scandalous. The Mexicans that voted for the alternation in the presidency in 2000, they did it not only to be get rid of an authoritarian and corrupt regime but in the search to obtain better standards of living for them and their families. That is the content of the change” (Aguilar Ruben. Newspaper El Universal. June 1, 2002).

It is, besides, illustrative to do a comparison among Latin-American countries. Mexico is found in the place number 54 in the Human index of Development of the UNO, but in that list, Costa Rica appears in the place number 43, Uruguay in the number 40 and Chile in the place 38; even various Caribbean countries appear above Mexico. The cases of these Latin-American countries are significant because, being in the same context of our region and being countries with smaller economic potential that Mexico, they come to surpass us inside the measurement done by the UNO.

Costa Rica is a small country of Central America with near 4 million inhabitants, in an under level of industrialization, with a deep democratic tradition, with a population with high levels of education, with a still considerable median class, with state institutions that have survived to the processes of privatization and that redistribute great part of the national wealth in the population, with large natural reserves cared and maintained in benefit of the ecology of all the planet. Some of these elements can illustrate the reasons by which the UNO has considered that Costa Rica has a better human development that Mexico.

On the other hand, Chile represents a notable advance in the IDH during the last decade of the XXth century, taking mainly some hints as the longevity of people, the educational level, the income level, the parity or disparity among the regions inside the country; “in the last decade, the special IDH for Chile was increased from 0.69 in 1990 to 0.749 in 2000. It signified that the country reduced in a 19% the distance that separates it from the ideal proposed as full Human Development. In the same period, all the regions of the country enlarged its Human level of Development in a considerable way” (UNO, 2002: 298). It is necessary to keep in mind, besides, the slow but notable advances in the consolidation of a democratic system in the decade of the 1990s.

Mexico took a very large step with the political alternation in the presidency of the Republic in 2000, and counts surely on a great economic potential; but the challenges of the human development are enormous so much in the field of the inequality of the distribution of the wealth as in the cultural and political environment; in fact, we do not reach still to have a consensus of the main political forces, a new social pact for improving in the human development; instead, it seems that we continue with the inertia of all inherited in passed decades, because the country has not taken decisive advances in the execution of a State reform.

In Mexico, another fundamental element to consider is the transparency in the institutional operation and the fight against corruption. What to do, for example, in a key point of a democratic system as it is the battle against the corruption? The inheritance left by the State party state (PRI) is burdensome: in 1999, the International organization of Transparency, in 99 analyzed countries, put us a scoring of 3.4 points, keeping in mind that the optimum qualification is 10 and the worst one is 0 (International Transparency. Berlin. October 1999). It is a similar situation in many countries of the continent: “the Latin-American countries are found charged not only by the poverty and the inequity but also by the weakness of the empire of the law, that is to say, the guarantee that the citizens and any business receive an impartial deal and well done on the part of the government, of the justice and of other institutions” (Economist, No. 8170, 05/13/2000:34). But in matter of transparency, although we can understand that Denmark is the country who had the best qualification, inside Latin America countries as Chile, Costa Rica, Peru, Uruguay and Brazil, they were catalogued above Mexico. It is a brutal inheritance with which we live; it is not the system alone that favors the illegality but also big part of the population we live in a generalized corruption culture that all we seem to accept as given almost for always.

Besides, if today we present ourselves in the search of better phases in our processes of development, one of the fundamental challenges is in the creation of a citizen participation culture where we can represent us in the search of consensus required by the country at the present and the next period during the XXIth century.

Not only the UNO but also even other international agencies as the World Bank (BM) or the International Monetary Fund (IMF) have stated with plenty of clarity that the way to fight the social deficit and the poverty in the different countries foes from the design of public policy and of governmental managements; in this design begin, we know the increasingly importance of the citizens organizations and the international pressures. In this sense, only the existence of a democratic political system (with various characteristics beyond the legitimate electoral execution of processes) can guarantee a better one design of the public policy, understanding that the citizens organizations have institutions that permit them to elevate their voices and to participate in the pacts among the different political forces; it signifies also a separation with the prevailing political culture during the XXth century, when every welfare depended on the power of the State. The perspectives of development for the future will depend then in a collective agreement, that they will have to be built among political forces and citizens organizations; the development of Mexico arises then from the institutional need of construction of a democratic political system, with a national pact with all the political forces in a reform of the State, and –the hardest-, with the creation of a political culture capable to build a collective imaginary of the possible country we want.

References

Contact the Author for a list of References.

Skill Shortages, Training Needs and HRD Strategies of MNC's in Mexico

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Abstract

This study, which has been carried out as part of the project "Skill Shortages, Training Needs and HRD Strategies of MNC´s in APEC Economies", examines important factors of this type of firms, through a survey of MNC's operating in Mexico. The experiences of MNC´s recollected in Mexico are very valuable in order to shed light in how these companies are developing appropriate knowledge management systems, by understanding specifically how they are coping with skill shortages and their role in upgrading them in order to face competition. Key issues are discussed such as: the extent of labour and skill shortages faced by these firms, current and future training needs and their human resource management, as well as their human resource management techniques. Gender issues are also highlighted in this paper. The findings are compared with the results obtained by MNC´s in other APEC members.

1. Survey Sample

The survey sample covered 625 multinational companies (MNC's), within four industries –manufacturing, banking and finance, insurance and business services; operating in eight APEC economies: Chile (30), Indonesia (61), Malaysia (100), Mexico (61), The Philippines (81), Singapore (111), Chinese Taipei (100) and Thailand (76).

With respect to industry distribution, the results from Mexico were very similar to average for all countries: 50% in Manufacturing; 10% in Banking; 36% in Business Services; and 3% in Insurance. These data were the closest to average among all participants. It can be said that the sample distribution is not too far from actual distribution: among the top 50 foreign companies in Mexico, 37 (74%) belong to Manufacturing and 13 (26%) to Business Services.

In terms of organizational size, the 501+ category has the largest percentage of companies among all categories, for the four industries analyzed in the survey. The 3rd and 4th categories together (more than 100 employees) concentrate more than 60% of the companies, in each industry. In Manufacturing and in Insurance, the figure is above 90%. These results are in line with the Official Business Classification according to the Number of Workers and Line of Business, that consider a company to be large in Industry when it has more than 501 employees and more than 101 employees in Services. MNCs are, in general, large companies in Mexico.

The percentage of large companies in Mexican data (3rd and 4th categories) is largest among all participants.

2. MNCs profile in the countries – Regionalization and Globalization trends

In the 1989-1994 period it was decided to take the structural reforms started years earlier to a more thorough level in Mexico. Trade opening, direct foreign investments, deregulation and privatization, and financial reform made the core of the adjustment program in line with the economic stabilization program.

Deregulating foreign investment portfolios allowed for an excessive affluence of foreign financial resources resulting in growing appreciation of the real peso exchange rate. This made more difficult the link between major exporters and domestic vendors. More and more intermediate goods were imported, hindering the massive emergence of Mexican exporters and exacerbating a situation where substituting Mexican consumer goods for foreign purchases made the economy less dynamic.

Many small and medium sized companies were forced out of business. Also a wave of mergers and acquisitions took place among Mexican companies, making in some cases, large corporatives mostly oriented to the external market (although it is also true for Mexico that an increasing number of small and medium enterprises from abroad are establishing). Thus a reduced dynamic export sector coexist with a large segment of a stagnant economy.

While average for all economies range between 75% and 90%, Mexican figures range between 50% and 60%. Among foreign parents, 75% of these reside in the Americas (mainly US) and 25% in Europe. There are none in Asia, Australia or S. Africa. Above result is very similar to Chile's, but very different from other participants, in which Asia is a very important residence of foreign parents. Mexican results are very consistent with the origin of Foreign Direct Investment: 66% from the US and 25% from Europe.

The survey indicates that by Industry, Manufacturing shows the largest extent of expatriation, while it is almost nonexistent in Banking & Finance. By Occupation, the largest extent is shown by managers, followed by production, while it is nil in Sales and nonexistent in Service. It is important to highlight, however that the extent of expatriation in Mexico is below average for all participants, in all industries and in all occupations, except in Manufacturing / Production. Certain kinds of specialized labour are very scarce in Mexico, so the above results are self explanatory due to highly technical work.

To raise the quality of labour, the government has increased its efforts to improve the domestic educational system. Financial resources allocated to education account for 6% of GDP and the purpose of the Secretariat of Public Education is to reach a 9 year basic education level to close the gap between the quality of domestic labour and the requirements in developed countries.

At the same time, companies are expected to participate in developing their labour. To this end, labour legislation included in 1978 a demand for businessmen to provide their employees with on the job training. The Secretariat of Labour and Social Welfare is in charge of promoting on the job training through different programs. At the same time, the Secretariat helps in joining the job supply and demand through the National Employment System (Banamex, 1998). To a great extent, applying these active policies to the labour market is geared to compensating for the absence of an employment insurance system.

In spite of efforts made by both the private sector and the Government, the population served by systems to train on the job is small. Accordingly, the results showed that the training level in Mexico is below average from all participants.

Developmental Trends of MNC's

By Industry, Manufacturing shows the largest percentage of output exported while Banking & Finance and Insurance export none. Such a thing, is reasonable mainly after the financial crisis in 1994. The banking system is focused in reinforcing its process and return in a healthy manner to intermediate the market and diversify its services.

Nine years after the crisis, Mexican commercial banks are starting to lend to the private sector. In 2000 it was 70% less in real terms, in comparison with 1994. Mainly US and European (especially Spanish) financial institutions have acquired significant stakes in the Mexican commercial banks and insurance companies, so recoverage is envisaged in the immediate future. It can be also said that the ability to raise capital has given Mexico's largest firms access to peso and foreign currencies, and has given multinational companies a significant competitive advantage with respect from the less favoured firms. That's why in spite of a strong peso, in the last few years, the export rate growth continued to maintain dynamic until 2000. Nowadays, the US economy slowdown has had an impact on it.

Mexico is among the ten most important exporting countries of the world, in absolute terms. Although compared with other APEC members ("mature and cubs" tigers), the percentage of exports with respect to GDP is low. Mexico presents one of the lowest percentages of output exported, only above those of Chile's and Malaysia's and well below those of the remaining Asian nations.

Developmental trend – expression of interest in expansion of business

For the participating countries, this indicator is shown to have an important positive correlation (around 60%) with both the size of the economy (Total GDP) and the level of imports, in both the Manufacturing and the Business Services Sectors. In the Banking & Finance and the Insurance Sectors, the main correlation is found with the per-capita GDP and is around –30%.

Since among participating countries, Mexico is the largest economy and among the three largest regarding exports and imports (after Singapore and Taiwan), but rather small in per-capita terms, because of above correlations Mexico tops the list in each industry and is well above average.

"Cautiously optimist" is probably the term that best describes the outlook among business people in Mexico for the years to come (AMCHAM, 2000: 21). This is the result of the changes that Mexico has experienced lately: politically and economically, that have resulted in positive expectations for the future, in spite of the problems it is experiencing in this moment.

3. The extent of skill shortages in MNCs

In Mexico, employing contractors is an extended business practice, firms more and more are trying to focus on their core businesses. The research of MNC's in Mexico reveals that the percentage of companies employing contractors is third largest in all industries, after Chile and Malaysia and well above average. All companies in Manufacturing and Insurance employ some form of contracting. Figure is above 90% in Services and above 66% in Banking & Finance.

The type of work most often contracted is related to Maintenance, as in almost all companies surveyed in all member economies, and specialized work reported as Others. Actually, Mexican figures are highest among all countries for those categories. In Security, Clerical and IT/Communication, Mexican figures are average, while they are well below average in Marketing and Production.

Regarding IT skills, the time required to recruit IT staff is similar to average for all countries and rather homogeneous among different occupations. Manufacturing and Services seem to take a little longer for the recruitment process than Banking and Insurance, with exception of network consultants (over 16 weeks to recruit).
Above results may be indicative of a certain level of shortage of IT skills. However, high reliance on Maintenance contracted work is probably related more to convenience than to an existing shortage of skills.

Summarizing, it has been recognized in Mexico that companies do not find professionals as at a pitfall when starting or expanding their activities. Although a relatively high percentage of companies (53%) in the survey experienced difficulty in the recruitment of professional staff, rather, it is more the case that describe Iradale and Mitchell (1995: 1), that there is a mismatch between skills required by industry and those currently available within labour force. This can explain why in Mexico the shortage of managerial skills are more prominent than other more developed APEC economies.

The perception of a negative impact of skills shortages in Mexico, by Industry, correlates negatively very highly, almost –100%, with the rest of the surveyed economies. Consequently, it is lower than average in both Manufacturing and Business Services and above it in Banking & Finance and Insurance.
In general, there is neither indication of a severe skill shortage nor a negative impact on growth.

4. Current and future training needs for skill and management development in APEC

Definitely, skill deficiencies is a factor that has exerted a negative influence for business expansion. This is especially true in the Northern States of Mexico, that are very tied to the US economy and in general to the external sector ("in-bond" activities take place mainly in this region).

Areas of training improvement

The survey shows that the skill with the largest need of improvement is management, with more than 70% of companies indicating it. Other important skills in this regard are: planning & problem solving (65%); communication (61%) and technical (46%) (Table 1).

By occupation, the main area is the training needs of New Professional and Technical Staff, with more than 90% of firms indicating medium to high needs. The requirements are similar for the 4 different industries. The needs for New Managerial Staff are almost as high though a little lower.

The more relevant aspects of training improvement are both the amount available and the cost of training, with 35% of companies indicating this.
In summary, management-related skills are the most important, along with the training needs of new staff in all its areas.

Evaluation of effectiveness of training programs provided by business and government

The participation in Government training programs is very small (17%), lowest among all countries. The perception of the effectiveness of these programs by participating companies is that they are moderately successful, regardless of the industry.

The main reasons for the small participation in these programs, are that they are mostly unknown to the companies and, when known, they are considered as vague and ill-suited for specific and well-defined purposes and rather general. On the other hand, the participation in group training is high: 50% or more for the sample and above average in all industries but Insurance.

5. HRM and International HR issues

Staffing plan

In the past, the staff expansion in Mexico was larger than the average for all countries.

This expansion was rather homogeneous among the occupations analyzed in the survey and particularly strong within the Manufacturing and Services industries.

This is in line with the rather strong growth experienced in the Mexican Economy during the last year, when a large percentage of the companies expanded and required larger staffs, as a result.

For the future, there is the expectation that all occupation staffs will grow, except Managers. The expected growth in Mexico will exceed that of the average country.

Recruitment methods

Private agencies and Transfers were the most significant channels of managerial recruitment by MNC's in Mexico. The former was especially important in Business Services and Insurance, while the latter was top in Manufacturing and Banking & Finance.

Media, the most important means of recruitment for managerial staff in all economies and industries in the survey, was seldom used in the Mexican case, not being used at all neither in Banking & Finance nor in Insurance (Table 2).

For the recruitment of Professional staff, the most frequently used method was the use of schools in all sectors, particularly in the Insurance industry, where all firms used it in the past. Internet, "word of mouth" and transfers were second in importance, very similar among themselves.

Again, the situation was very different from the average for all economies, where the main method was Media, followed by Internet (Table 3).

For recruiting other types of staff, Schools and Internet were the most important methods of recruitment. "Word of mouth" was specially important for the Insurance sectors. Again Media, the most important method of recruitment for the average of all economies and industries, was seldom used in the Mexican case.

Difficulty in recruitment of certain categories of staff

In Mexico, most industries found difficulties in recruiting professionals, except the Banking & Finance Sector that reported the recruitment of sales staff as the one having the biggest difficulties. The situation in Mexico was similar to the average of all the economies in the survey (Table 4).

Most of the MNC's surveyed in Mexico considered Professionals to be the occupation where they will have the greatest difficulty in recruitment in the future. On the contrary, clerical was the occupation thought by MNC's that will have the least difficulties.Again, this situation was similar to the average of all economies and industries in the survey (Table 5).

Regarding the time needed for staff recruitment, IT Maintenance, IT Technician and System Analyst were the occupations showing the smallest required amount of time. On the opposite side, the recruitment of Net Consultants took the longest in the Insurance Industry (Table 6).

Dynamics of outsourcing

The most important reason for outsourcing for all the MNC's surveyed is related to having more flexibility, except for the business services, where outsourcing is used as cost saver. These results are in line with the other APEC economies. Lack of skills was classified as the least important reason to hire external services (Table 7).

Staff turnover – managerial compared with other categories of staff

67.35% of the enterprises reported a staff turnover rate less than 5%. The highest rate is found in Professionals, while the lowest is in Managers.

Mexican turnover rates are lower than average for all economies / industries found in the survey (Table 8).

Total and average training expenditure to measure the extend of training taken place in Firms

The survey data showed that the Insurance sector has the highest expenditure in training. Manufacturing industry expends, on average, more in managers; Banking & Finance in clerical staff; business services and insurance companies in professional and technical staff, due to their stronger requirements in specialized personnel (Table 9).

Training methods or programs

Most of the surveyed MNC's used off-job training methods. This is in line with the emergence of a variety of alliances between enterprises training centers and universities. Corporate Universities appeared as the most preferred mode for outsourcing in training. The main objective of Corporate University establishment is to teach and learn from internal experiences in the business work.

Training through governmental bodies and employers group

Among the countries that took part of the survey, Mexican companies reported the lowest percent of use of Government Training Programs. This issue has already been discussed in the paper. Only 20% of firms in Manufacturing and in Banking & Finance said that had used those programs; 9% in Services and none in Insurance. These results are much lower than the averages for all economies, where the percentage ranges from 27.5% in Insurance to 47% in Manufacturing.

6. Gender issues

Occupational segregation

In the last ten years, an increasing number of women are incorporating in the labour market (40% approximately of the Economic Active Population are female). More older female (30 years and up) are participating in activities especially linked to the "in-bond" plants.

Two main characteristics in the Mexican labour market, is that female participation is more frequent in partial time jobs, due to their family duties. Also they earn, in average, ¾ of men's wages and the open unemployment rate among women is higher than the ones for men, 2.5% vs. 2.2%, respectively (STPS, 1999). The lack of sufficient family income in Mexico will continue demanding a great involvement of female labour and early incorporation into productive activities, which of course have severe impacts on school average of the labour force.

The participation of women in employment is among the lowest for all countries in every occupation analyzed in the survey, but Professionals. By industry, female employment tend to be lower in Manufacturing than in the other 3 industries, specially in managerial and production positions (Table 10).

Above results are in line with the historical low participation of women in employment due to, among other things, cultural and social influences. This has been particularly true at the directive and managerial levels and in technical and scientific activities.

It is true, that economically active population in Mexico, will not continue growing by increasing male share (economic active population/population older than 12 years), but by expanding the female one. In fact, among the OECD countries, Mexico shows the smallest shares, only comparables with Turkey and other countries of the south of Europe (OECD, 1997: 87). In Mexico female share is 38% compared to 70% in USA and 65.3% in Canada.

7. Recommendations

From the analysis of the survey, it can be said that in order to achieve greater productivity and quality that leads to greater specialization and a better organizational climate in such a competitive world, enterprises have to invest in human capital. In Mexico more and more companies are looking to be certified as meeting available standards that a knowledge-based economy requires. MNC's, as well as other firms, need to develop a clear Human Resource policy.

Regarding the participation of the Mexican Government in training programs for addressing skill shortages, it can be said that in has been very limited, much lower than in the other economies surveyed in the study. Lack of knowledge about these programs, as well as the generalized perception that they are rather vague and do not address the most pressing needs in the firms, are often cited as the main reason for such a result.

Since there is an important potential for those governmental programs for improving labor skills, the Government should make an important effort to have firms know about those programs and, at the same time, discuss widely with those same firms and related institutions in order to figure exactly what are the needs that should be addressed and prepare very precise training programs that will help overcome the detected skills shortages. The role of the Government should be a very active one in this regard.

This survey has been able to identify some of the most important training needs for the MNC's in Mexico. Among them, the following can be mentioned: I) Management; II) Planning and problem solving; III) Communications.

In order to address and improve those skill shortages, effective education and training measures must be used, in order to make an optimal use of the scarce resources devoted to this end.

The results of this survey, indicates that Group training can be an effective method for training personnel and help overcome skill shortages.

Another method that has proved its effectiveness in Mexico for training purposes, is the use of Cases, to address specific problematic situations. This method is well received since it is perceived as a specific one, able to cope with "real" situations, as opposed to only "theoretical" aspects, that is often one of the reasons cited for a program to be unsuccessful.

Finally, it must be noted that off-job training methods have proved to be the most effective for the Mexican case. In such a case, training devices as "Corporate Universities" seem to be adequate means for addressing the needs of training in Mexican enterprises.

References

Contact the author for the list of references.

TABLE 1MEXICO: PERCENTAGE OF FIRMS INDICATING NEEDS FOR SKILLS IMPROVEMENT BY INDUSTRY AND SKILL

	Technical	*Management*	*Multi-skilling*	*Interpersonal & Communication*	*Planning & problem solving*	*Literacy & Numeracy*	*Others*
Manufacturing	63.16	72.41	31.03	62.07	72.41	17.24	6.67
Banking & Finance	60.00	40.00	40.00	60.00	60.00	40.00	0.00
Business Services	50.00	71.43	40.91	59.09	54.55	4.55	0.00
Insurance	50.00	100.00	0.00	100.00	100.00	0.00	0.00

TABLE 2MEXICO: RECRUITMENT METHODS FOR MANAGERIAL STAFF BY CHANNELS & INDUSTRY

	Media	***Word of mouth***	***Govt. agency***	***Private agency***	***Schools***	***Union centres***	***O/seas contract***	***Trans-fers***	***Inter-net***	***Others***
Manufacturing	13.33	33.33	3.33	40.00	23.33	0.00	13.33	43.33	30.00	10.00
Banking & Finance	0.00	33.33	0.00	16.67	33.33	0.00	0.00	50.00	33.33	33.33
Business Services	4.55	31.82	0.00	68.18	27.27	4.55	4.55	45.45	31.82	13.64
Insurance	0.00	50.00	0.00	50.00	0.00	0.00	0.00	50.00	50.00	0.00
All industries	8.33	31.67	1.67	48.33	23.33	1.67	8.33	45.00	31.67	13.33
All Economies/ Industries	**58.89**	**30.09**	**3.10**	**47.52**	**4.79**	**0.20**	**5.85**	**24.58**	**23.21**	**11.63**

TABLE 3RECRUITMENT METHODS FOR PROFESSIONAL STAFF BY CHANNELS & INDUSTRY

	Media	***Word of mouth***	***Govt. agency***	***Private agency***	***Schools***	***Union Centres***	***O/seas contract***	***Transfers***	***Internet***	***Others***
Manufacturing	23.33	26.67	6.67	16.67	56.67	3.33	3.33	36.67	43.33	13.33
Banking & Finance	16.67	50.00	0.00	33.33	50.00	0.00	0.00	33.33	16.67	33.33
Business Services	22.73	50.00	4.55	36.36	54.55	4.55	0.00	45.45	45.45	18.18
Insurance	0.00	50.00	0.00	0.00	100.00	0.00	0.00	0.00	50.00	0.00
All industries	21.67	38.33	5.00	26.67	56.67	3.33	1.67	38.33	41.67	16.67
All Economies/ Industries	72.22	34.77	6.24	40.41	20.77	0.79	4.31	15.06	35.85	9.94

TABLE 4MEXICO: PERCENTAGE OF FIRMS INDICATING PAST RECRUITMENT DIFFICULTIES BY OCCUPATION & INDUSTRY

	Managers	***Professionals***	***Clerical***	***Sales***	***Service***	***Production***
Manufacturing	37.04	43.33	7.14	26.92	22.73	17.24
Banking & Finance	20.00	16.67	16.67	33.33	0.00	0.00
Business Services	45.45	71.43	28.57	44.44	25.00	28.57
Insurance	50.00	100.00	50.00	50.00	0.00	-
All industries	39.29	52.54	17.54	34.62	20.93	20.00
All Economies						
Manufacturing	29.89	55.43	7.39	21.30	12.14	26.89
Banking & Finance	30.99	37.31	17.39	17.39	6.38	0.00
Business Services	31.98	48.24	14.51	32.00	14.71	19.54
Insurance	25.64	50.00	18.92	35.71	10.00	10.00
All Economies/Industries	***30.46***	***50.52***	***11.87***	***25.33***	***12.22***	***22.74***
N	***568***	***580***	***556***	***454***	***409***	***365***

TABLE 5MEXICO: PERCENTAGE OF FIRMS FUTURE RECRUITMENT DIFFICULTIES BY OCCUPATION & INDUSTRY

	Managers	***Professionals***	***Clerical***	***Sales***	***Service***	***Production***
Manufacturing	30.77	25.93	18.52	36.00	23.81	18.52
Banking & Finance	20.00	50.00	20.00	33.33	0.00	0.00
Business Services	42.86	52.38	20.00	41.18	18.75	14.29
Insurance	0.00	50.00	0.00	50.00	0.00	-
All industries	33.33	39.29	18.52	38.00	19.05	18.60
All Economies/ Industries	31.49	46.10	9.47	24.84	11.47	18.13

TABLE 6. MEXICO: TIME PERIOD FOR RECRUITMENT OF IT STAFF BY OCCUPATION AND INDUSTRY

	Proj. Manag.	***Programer***	***Sys. Consult.***	***Sys. Analyst***	***Com. Tech.***	***Net. Consult.***	***IT Engi-neers***	***IT Mainte-nance***	***IT Techni-cian***
Mexico									
Manufacturing	3.0	3.0	3.0	2.5	3.0	3.0	3.0	2.0	2.0
Banking & Finance	2.0	2.0	2.0	2.0	2.0	3.0	1.0	1.0	3.0
Business Services	3.0	3.0	3.0	2.0	3.0	3.0	2.0	2.0	2.0
Insurance	2.0	2.0	3.5	2.0	3.0	5.0	2.0	2.0	1.5
All industries	3.0	3.0	3.0	2.0	3.0	3.0	2.5	2.0	2.0

TABLE 7MEXICO: CONTRACTING OUT BY PURPOSE

	More flexibility		***Special services***		***Skills lack***		***Cost cutting***	
	median	mode	Median	Mode	median	mode	median	Mode
Manufacturing	2.0	1.0	1.5	1.0	4.0	4.0	3.0	3.0
Banking & Finance	2.0	1.0[a]	2.0	2[a]	4.0	4.0	2.0	1.0[a]
Business Services	2.0	2.0	3.0	3.0	4.0	4.0	1.0	1.0
Insurance	2.5	1.0[a]	2.5	2.0[a]	2.5	2.0[a]	2.5	1.0[a]

Ranking order from 1-4 indicating the most important reason as '1' to the least important reason as '4' for contracting out. Median indicates that at least 50% of the sample population respond Mode refers to the most frequent response by the sample population[a.] Multiple modes exist. The smallest value is shown

TABLE 8MEXICO: PERCENTAGE OF TOTAL STAFF TURNOVER BY INDUSTRY

	<5%	***6-10%***	***11-15%***	***>15%***	***N***
Manufacturing	74.07	11.11	7.41	7.41	27
Banking & Finance	50.00	0.00	50.00	0.00	2
Business Services	61.11	22.22	5.56	11.11	18
Insurance	50.00	0.00	50.00	0.00	2
All industries	67.35	14.29	10.20	8.16	49
All Economies/ Industries	**44.99**	**14.29**	**15.27**	**25.45**	**100.00**

TABLE 9 AVERAGE TRAINING EXPENDITURE PER BY OCCUPATION AND INDUSTRY (US$)

	Manager	***Prof & tech***	***Clerical***
Manufacturing	7,371	3,359	1,785
Banking & Finance	3,736	4,111	7,236
Business Services	16,956	88,815	7,488
Insurance			
All industries	800	250,200	500,200
All Economies/Industries	**3,283**	**3,817**	**2,026**

TABLE 10MEXICO: PERCENTAGE OF FEMALE EMPLOYEES BY OCCUPATION & INDUSTRY

	Managers	***Professionals***	***Clerical***	***Sales***	***Service***	***Production***
Manufacturing	11.25	32.59	40.27	27.35	30.46	20.73
Banking & Finance	25.61	30.30	41.06	18.33	41.43	37.53
Business Services	18.53	37.45	46.15	32.79	27.32	12.32
Insurance	22.92	43.65	28.27	45.11	60.00	-
All industries	15.50	34.64	42.22	29.31	30.50	18.68
All Economies/ industries	23.94	32.30	67.74	38.60	34.15	27.20

Human Development Investment in Mexico: Selected Indicators and Some Reflections

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Abstract

This paper, considering the human development situation in Mexico, highlights education expenditures as a real investment. At least the public speech recognizes and talks about the human factor in development and its importance as a conditional requirement for any country that wants to attain a sustainable development. You can find that in our country we are far from being consistent with what is said and what is actually done.

We begin by briefly exposing some of the main theoretical approaches that focuses on the educational budget as an investment instead of an expense. Who are the involved actors and what are theirs roles. In the second part we deal with the meaning of this educational investment and discussing other issues. It brings selected international and national data to make both international and national comparisons about what Mexico has done and what it is currently being done in the area of educational investment. We may be proud for the quantitative success achieved in Mexico during the second part of the Twentieth Century, however in quality aspects there is still much lacking. Next we present a selected short summary of data collected on 20 of the top 100 public and private enterprises in Mexico. This data is used to analyze what organizations are currently doing for its member human development. Expenditures in education must be considered an investment— in all the ways— for the national agenda if we truly believe that the human factor is directly linked to the present and future sustainable development and progress of Mexico. It is our wish that these basic thoughts will become a platform for a deeper dialogue concerning what we are currently doing, and what we hope and need to achieve for the common welfare for the citizens of our future.

Introduction

At least in the speech, there is no doubt in the fact that everybody accepts that the human factor is essential for sustainable development of countries. But, is such truth taken into consideration in public and private investments? Even when development and progress of a nation depend on multiple factors, they are closely linked with people's quality, their knowledge, their skills, abilities and life styles. In public policies of several countries around the world the human factor has been a priorit, to promote education and development of people.

Even though education is considered as "a central element for growth and economic and social development and even for the expansion of the more accepted and compatible equity levels with democratic cohabitation" (Aguilar Broughton, 1999), it is facing an essential problem. The economic problem, the struggle for necessary resources which are not enough to face the needs and that will always be competing against other social priorities as well as with private interests. It is then the moment to ask how important (or income-producing) is to assign resources for this matter. We are interested in some reflections about the concept "education as an investment"; and, in reviewing with some recent data, if in Mexico (mainly referring to state and private enterprises) there has been a real policy, in assigning resources for such matter.We center this paper in the concept of education as an investment. We will analyse some theoretical contributions and other data to make the resources assigning visible.

1. Theoretical Contributions. Some Considerations

Scholars contributions have been important - mainly in the education economy field – to generate a vision of education as an investment more than as an expense. If, in economic terms [1], we understand inversion as "using the capital with the hope to obtain a benefit, that will be measured in money and that will allow us to keep the invested capital, to produce an income for the investor and do social labour" (Hermoso, 1997:80), we can then classify in two the possible analysis axes of an investment: the first one is interested in knowing what is expected with such investment, where must the benefits be and with which possibilities. The second axe asks who are the actors that participate in resources planning, programming, administration and expenditures.

Three focusing about the investment purposes.

a) A first focusing is in the micro level – individuals – it has the purpose to find correlations in education, work, job and salary and its final purpose is to find the possible correlations between scholar preparation and possibilities of job and social movement. (Cfr. Fermoso 1997:165) b) The second focusing is the productivist, interested in measuring the possibility to generate resources regarding the given costs. The concern about this focusing is to come trough education to the economical growth and, in this matter, we find coincidences in studies where education has a strategic roll for the economical growth of countries (Psacharopoulos, 1996) [2]. As there are opinions in favor of such argument (Cfr Fermoso 1997:125-140) there are also issues that recognize the good points, but point out that there have been politicians, planning people, and employers who have exaggerated in the education roll. "Certainly education is only a factor, even though a very important one, in a set of conditions that determine productivity and economic competitiveness : also other ones like delinquency levels, social benefits, political participation, health and so on. Education has a wide impact on each of these areas, if there are the necessary support conditions and factors". (Levin and Kelley 1996:202) Anyway there is a coincidence in the fact that it is a very important factor. In this we find the analysis of residual factor and cost—benefit like analytic techniques searching "quantified causal relations with which behaviors that rule economic phenomena can be predicted" (Moreno, 1998:68.) In this perspective we can set the ongoing lift made by the permanent education, taken it to speed up economical growth. The permanent education acquires a dimension of a strategic investment that carries movement of various kinds of agents: educational system, private trainees, employers and salary representatives (UNESCO 1996:77). Nevertheless, it is not possible to ask educational systems to form manual labour for a steady industrial employment; it is necessary to form people for innovation, people that are able to accept changes, to adapt themselves to a world that is changing day by day and to dominate such change (UNESCO 1966:78) c) At last the third focusing refers to the possibility to achieve more than the economic growth, the development and progress of countries through education investment. We find this concern in Delors' Report from the UNESCO. The focusing comes from a premise that the simple economic growth objective is not enough to guarantee human development (UNESCO 1966:85). There exist two reasons why it is in certain manner put in doubt: not only due to its unequal character, but also due to the high costs regarding employment and environment. These are, no doubt, the deadlocks to where a production model inevitably conduces. The ones that with the years have made the United Nations specialized bureaux to consider development in a more extent way which goes beyond the economic order and includes ethic, cultural, and ecological dimension.

The PNUD (United Nations Program for Development) in its first report about human development (1990) proposed that the leading process to extend people's options is considered human development. It mentions three essential options for people, these are: being able to have a long and healthy life; being able to learn; and being able to have the necessary resources to enjoy a good level of life. If people does not have those essential options, they lack many other opportunities.[3] This program also points out that the economical development concept is much more extensive than the one in the established theories about economic development. It mentions the characteristics of such focusing to confront them with that of human development. The model of economical growth is among them and it refers to the PNB (Gross Domestic Product) increase instead of the human life conditions improvement. When we consider human resources development, we are talking that human beings are handled as an input in production process: a mean and not an aim . In Social Welfare focusing human beings are considered as beneficiaries and not as changing agents in the development process. The basic needs focusing are set in providing some fringed population groups with goods and material services, instead of doing it with all spheres. In the other hand in the human development concept is the production and distribution of products and the extension and improvement of human ability. Human Development includes the mentioned focusing, but surpasses them. In Human Development all social issues are analysed – namely as economical growth, commerce, employment, political freedom or cultural values – from the human being point of view. Therefore, Human Development is focused in extending human options in both industrialized and developing countries (PNUD report on Human Development 1995 cf. by UNESCO 1996) recent studies as the ones of the OCDE (2002), give a positive impact of education in development. The Human Development trend more than any other option appears the only possible option (Moreno: 91)

1.1 Protagonists

The second main axe has brought polemics about who is responsible - or who might be interested – in investing on education. The state?, or the private sector?, at all levels and, in all cases?. As a best way of development, there are scholars who emphasize that the state is obliged to provide education, not only in basic levels but up to professional via public universities and research. (cfr. Riveros Cornejo, 2000) On the other hand, authors like Nicholas Barr (1996), who considers that financing might not be trusted only to one mechanism. He suggests a series of alternative politics for financing such as loans, private financing, research contracts, and commercial activities for institutions as well as for students. In as far as educative investment of enterprises concerns, the Economy Nobel Award 1992, Gary S. Becker (1993) points out that the roll of enterprises and the training in job positions is generally misconceived. The author mentions that unfortunately there are few trusting statistics about total investment of knowledge and techniques acquired on a job. But evidences - as he affirms - suggest that such investments can be as important as learning acquisition investments in schools. (Becker, 1993:103.) Finally, also talking about human capital investment that the enterprise makes and in the dilemma of who must pay for education, we find authors such as Masanori Hashimoto (1996) who argues that investment and profit must be shared; so to say, the employee must help the employer with costs and fees to be able to share benefits too.

2. Mexico in the International Context

2.1 Investment in human capital development

As it has been said, today, more than a few years ago, there is a consensus that interdependence in education, growth and social-economic development go beyond the own field, especially in an emerging country as ours. The new thing in the golden triangle they conform, is that the educated human factor be there, be accepted and have naturalization card as the main active in a family, organization, institution, a country, or the whole world. There is no doubt that we all accept, at least in the speech, that the human factor is an essential requirement for sustainable development. That truth, is it considered in investments? Let us see something in the international panorama. According to basic statistics comparison (Source: OCDE, Economic Studies: Mexico, July 2000) the common Mexican Government expense in 1997 according to the next chart which includes the mentioned OCDE study, and includes, in our country's case Public Sector and Public Enterprises was, only an 8% of the GDP (PIB = Gross Domestic Product for initials in Spanish.) If we carefully go through the next chart (No.1) and order the GDP percentages, we were in the last place of member countries alphabetically ordered in a descendant vertical order starting on the left upper corner. The other countries' data also refers to 1997, except when other date is expressed in parenthesis.

TABLE 1. PERCENTAGE OF EXPENSES IN GOVERNMENT'S GOODS AND SERVICES

COUNTRY		COUNTRY		COUNTRY		COUNTRY		COUNTRY	
Germany	19.4	Spain	16.2	Italy	16.3	Portugal	18.6	Korea	11.1
Australia	16.7	U.S.A	15.4	Japan	9.6	United Kingdom	20.3	Denmark	25.2(96)
Austria	19.4	Finland	20.9	Luxembourg	13.3	Czech Republic	20.2	Spain	16.2
Belgium	14.4	France	19.3	Mexico	8.4	Sweden	25.8	Hungary	21.9
Canada	20	Greece	18.7 (95)	Norway	20.2	Switzerland	14.1	Ireland	13.1
Turkey	12.3	Poland	17.3	Iceland	20.5	Netherlands	13.7	New Zealand	15.2

Source: OCED Economic studies 1999-2000: Mexico, final appendix: basic statistics, international comparisons.

Fortunately there have been some changes and numbers have gone up; not only in Mexico but in the whole OCED. During the year 2000 in countries members of the OCED public expense reached an average of 45% in GDP. Sweden and Greece are up 50%; in Mexico, even it advanced, public expense was less than the half media, contributing only with 20%. (OCDE Economic Studies: México 2000).[4]

In this same report dedicated to Mexico, in the third part under the title Development of Human Capital as a Priority other interesting data about education investment are exposed.[5]

?? The average investment of GDP for education was 5%

?? Mexico invested 4.8% of GDP. It was on the 23th. place, between Ireland and Korea. There was a total of 32 countries.

?? The one that invested the most was Sweden with a 7% of GDP

?? The difference resulting in Mexico's scholar population, as one of the biggest in the OCDE - approximately 1/3 (30 million) of total population is registered in the SEN (Sistema Educativo Nacional, Domestic Education System) – and takes one of the lowest places in the GDP percentage provided for education.

?? Let us make reference to education equity that is officially one of the national education objectives. The authors of this report say, as anyone can confirm, that in Mexico the opportunity cost and the probability to comply with scholar cycle continues being "closely linked to parents income level."[6]

Delors Report to UNESCO (1996) confirms the human development basis, when he proposes to lead education to make scholars : 1) learn to know; 2) to do; 3) to live with others; 4) and to be, and he calls them "The Four Pillars of Education."[7] With that purpose, the first thing we must change in Mexico is the attitude and the way we see public budget as an "expense" and consider it as an authentic investment in human capital. Instead of looking at public budget as a lost of money and with no profit we must see it in a new way: discover the middle and long term profits hidden on it. With a new key prospect for poverty, which increased in the last decades we have regretted: education enrichment gives the best answer to poverty and the generalized low self esteem in Mexican people. Consequently our international competitiveness will never go beyond what we are, our principles, culture, education and the knowledge we can achieve through education that is within everybody's reach. An educated nation will have more participation and will be more critic. The developed talent is the only matter that will change people and will allow them to contribute to the change and the national progress. To be convinced of that means a radical change in concepts and attitudes on the authorities and social leaders : to firmly believe in Mexicans, in their permanent education, in their capacity to grow and develop trough a better general education system. That is the only way for Mexicans to have a promising future.[8]

2.2 National Education System. Cross section

According to data in the National Education Program 2001-2006, the investment, in 2001, reached 6.2% of GDP, with a tripartite participation, as represented in chart No. 2 (Source: National Education Program 2001-2006:66) : The Federal Government contributed with 4.2%, the State Governments and Municipalities 0.8%, (entirely a total of 5%,) and Private Sector 1

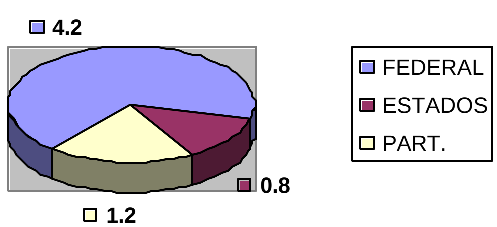


CHART 2. EDUCATION INVESTMENT IN PROPORTION TO GDP. YEAR 2001

In the national global group, pupils, teachers and educational institutions support is divided as represented in chart 3, in a small 12.5% on the Private sector and in a major part of 87.5% by Public support. (PNE 2001-2006:68).

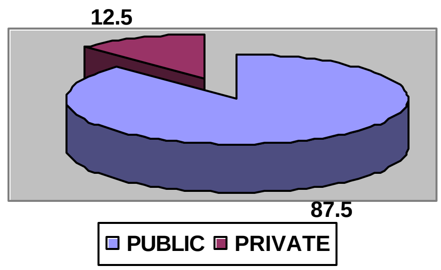
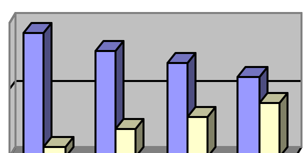


CHART 3. SUPPORT BY SECTORS

This data is not exactly reflected in the GDP percentages, because if examined by education levels it is not homogeneous. Furthermore, as shown in chart 4, there is a growth or decrease, depending on how it is seen, proportionally inverse in both ways of the scale. While Private sector only maintains 7.7% of basic education, the Public sector maintains 92.3%. Public education diminishes to 78.7% in middle education and Private sector participation is almost tripled to 21.3%. Private investment goes up and reaches a 30.3% in superior levels and the Public reduces to the remaining 69.7%.



	BASIC	MIDDL	HIGH	GRAD
Public	92.3	78.7	69.7	59.4
Private	7.7	21.3	30.3	40.6

CHART 4. INVESTMENT COMPARISON BY EDUCATIONAL LEVELS

In this last level grade studies is registered. In this matter Public sub system has 59.5% of enrollment, while Private sub system reaches 40.6%. In the same document it is mentioned that "pupils' federal expense also shows important differences among federal entities…reproduces national inequality instead of balancing it…"; or makes it clear that "a high portion of resources…very often more than 90%, goes for personal services. For this reason the remaining resources are not enough to cover operation expenses, and for the investments that a high quality education requires." (PNE 2001-2006:66)

2.3 Some Educational Offering Parameters 1950-2000

As a comparison background, let us say that in the late 20's last century, the scholar average of the country's As a comparison background, let us say that in the late 20's last century, the scholar average of the country'sinhabitants was just 1 year and illiteracy went by the 65% (PNE 2002-2006:57.)

For the year 1950, when the national census went up to 25.8 million inhabitants, the National Educational System had 3.25 million students, which means 12.59% of the total. In round numbers we can say that the scholarity rate was 1 of each 8 inhabitants (SEP Public Education Department, 1999). Twenty years later, in

1970, the country had 48.2 million, with a rate of inter census growth of 3.2 (Gómez López, 1997:21) from them 11.5 million were registered in Mexican schools of all types and levels, what makes 23.92%, or in round numbers comes out that a little more of 1 o each 4 inhabitants (PNE 2001-2006: 58)

According to the most recent census data, in 2000 we were 97.4 million inhabitants. The scholar enrolment went up to 29.7 million; needles to say that 30.46% or in round numbers 1 of each 3 inhabitants (PNE 2001-2006:58.), were n the National Education System : This can be seen in chart 5:

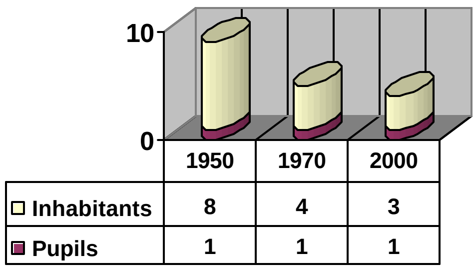


CHART 5. COMPARISON BETWEEN REGISTER AND POPULATION

Indeed, during the second half of the XX century, together with demographic growth, the country has made great efforts to highly extend educational offer. Certainly there are students, spaces, institutions, schools, programs, etc. of excellent quality; but plainly estimated it national education media —7.8— and the lost of students who started the first grade of Elementary School and followed to when they finished the Third Education level is a call in pro to improve the investment in qualitative issues. (Papua Nesrala:100.)

3. Bussiness Investment in Mexico, in as Far as Training and Development Concerns

We want to comment some points about the special number of magazine Mundo Ejecutivo (Executive World) where the100 enterprises that more invest in Mexico are studied (Mundo Ejecutivo, 2003.) In order to face global reality, enterprises see investment as a main and essential allied for their present and future. Those who invest in Mexico – national or foreign capitals – believe it is as a priority for good functioning to invest in the next matters: 1) Training and Development of Human resources 2) Technological Development and research 3) Technological and Informatics Systems, 4) Modernization and Equipment, 5) Installed Capacity Expansion, 6) Acquisitions, 7) International presence, and 8) Marketing.

The 100 enterprises that invested more in Mexico,[9] during 1997-2001 represented 29.5% and 70.5% Public and Private Enterprises, respectively. The investment surpassed the140 billion dollars – 80% by Mexican corporations. As can be foreseen, for the period 2002-2006 that proportion will considerably vary up to a major investment of Public Enterprises, that is estimated to represent 51.9%, while the Private Enterprises will represent 48.1%. Unfortunately, it is a matter of concern that during the same period 1997-2001 less than 1% of enterprises' total expense was assigned to Development and Education of Human resources, as this is the most important strategic activity. For investments planned for the period 2002-2006 (estimated in near of 150 billion dollars for the mentioned 100 enterprises that more invest in Mexico) the expense for Technological Development and Research Activities, Marketing, and Human Resources Education is not displayed.Regarding investment in Human Resources Development and Education, in Mexico, neither the Government nor the Private Sector have invested enough to create professionals and high quality workforce. According to the speech, most of the enterprises believe people are their principal active ; however, the expense assigned for their permanent education is disregarded and mostly used for training and development. This expense is not more than 1% of the annual investment budget, even for the 100 enterprises that more invest in Mexico –including PEMEX that was highlighted with 15% of the total invested by all of them; even though its expense for this matter was only a 0.6% of its total investment.

The one distinguished was Microsoft, as it designated 62% of investment to Human Resources Education. Another enterprises that also designate a good proportion of resources for this so important activity are: The Coca-Cola Company (Mexico), Grupo Comercial Mexicana, Grupo Bimbo, Grupo Modelo and Cemex, among others. This enterprises are an example to make clear that investing in Human Development is so important that they were allowed to generate jobs and, at the same time, to increase their incomes, their revenues and production flux by employee. As it is shown on chart 6:

TABLE 6. ENTERPRISES THAT MAKE MORE INVESTMENTS: THE FIRST 20

Enterprises that invest more in Development and Training of Human Resources				
	1997-2001			
ENTERPRISE	Total amount in MDD	% of the amount	Net income in 2001 MMD	Average increase 1997-2001
Petróleos Mexicanos	186.0	0.6	46,465.4	5.6
Grupo Cintra	85.0	12.0	3,125.4	7.9
The Coca-cola Company**	80.0	3.2	2,504.1	22.6
Grupo Comercial Mexicana	77.8	12.0	3,616.5	12.9
Cemex	76.0	1.1	6,944.3	14.7
General Electric	75.0	2.7	3,711.6	10.1
Grupo Televisa	64.2	6.0	2,150.9	5.7
Microsoft	56.0	62.2	152.0	15.7
Aerovías de México	47.7	14.5	1,445.5	6.8
Grupo Mabe	42.5	5.0	1,663.4	14.0
Grupo Bimbo	42.0	3.2	3,703.2	12.7
Grupo Modelo	40.0	2.0	3,518.7	16.3
DaimlerChrysler Group y Subs.	40.0	1.7	9,294.6	9.3
Volskwagen de México	39.5	3.8	7,004.4	19.4
El Puerto de Liverpool	39.3	7.2	1,999.4	25.0
Grupo Omnilife de México	35.8	16.0	700.0	36.8
Kimberly Clark de México	30.0	5.1	1,710.1	7.6
Grupo Vitro	25.0	1.4	3,002.0	5.2
Compañía Mexicana de Aviación	24.9	6.4	1,349.4	7.0
CIE	20.0	2.8	550.2	56.6

Source: Mundo Ejecutivo, March 2003

The need to establish conditions and strengthen mechanisms so educational and productive sectors can effectively communicate and cooperate with each other will be more urgent each day. In modern societies, establishing a system to create and accumulate work competition in schools and enterprises is a priority, as globalisation has strong competition and the only way to face the international challenge is raising the quantity and quality of Human Resources. (Llamas Huitron, et al: 2000:395-396) Wasting of talent and human development, has a very high cost. A country that is set aside from generation, reading, interpretation and making use of information and knowledge has not an outstanding range in the global planet nor in the concert of the third millennium nations. To really consider it as an investment and not just an expense or wastefulness, we must obtain healthy effects, changes, reorientations. That promotion and development of the human factor really be number one's priority. We hope that this going over is good to orientate and stimulate the ones who decide distribution of Public and Private Investment in order to consider it as follows: Investment in pursuit of better horizons for national welfare.

References

Contact the author for a list of references.

End Notes

[1] From an economic notion of investment we can see that economists in education consider investment as more than just money spent. They see – when talking about investment in human capital – other types of investment such as time, health, sports and recreation.

[2] George Psacharopoulos (1982) fulfils a very interesting synthesis about how education contributes to economic growth. In said synthesis he gives data of several countries so as opinions of the most important authors who have written about that and he concludes that the contribution of education in economic growth is evident.

[3] The report clears that human development does not end there. Another options, interesting for many of them, go from economic and social political freedom to the opportunity to be creative and productive and enjoy of personal self respect and guaranteed human rights. (PNUD. Report on Human Development 1995. Pages 15 and 16. Harla.Crf. by: UNESCO 1996)

[4] Cfr. "OCDE, Estudios Económico.M éxico", Parte III, pp. 75 y ss.

5 Cfr. Op. cit. pp. 95 y ss.

6 Op.cit. p. 100

7 Cfr. Jacques Delors, La Educación encierra un Tesoro, informe a la UNESCO. Edit. Santillana, Madrid, 1996, pp. 88 y ss.

8 Cfr. Gabriel Arturo Sánchez de Aparicio y Benítez, con José Luis Arizti Garay y Javier Fernández-Villanueva Salcido. Guadalajara, Jal., julio-septiembre de 2000. "El sistema educativo, un problema común apartidista. Propuestas de cambios en la educación en pos de un nuevo país".

9 Entre ellas se encuentran: Petróleos Mexicanos, Teléfonos de México, Comisión Federal de Electricidad, América Móvil, Cemex, Grupo Carso, Grupo México, Grupo Alfa, General Electric y The Coca-Cola Company.

The Relevance of Reference Groups for Mexican Americans

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Abstract

Reference groups are an important element in the diffusion process of innovations. Understanding the needs that reference groups satisfy for individuals and the reasons why certain groups become relevant can be useful for introducers of innovations. National-cultural differences as the ones reflected in Hofstede's Individualism Index, translate into behavioral differences between members of collectivistic and individualistic cultures. How relevant are reference groups for Mexican Americans? The conducted literature review revealed US Hispanics' reliance on family members and peers, as reference groups, to satisfy a need for information and guidance. But do Mexican Americans and Mexicans use reference groups similarly? An interesting possibility for future research would be to conduct a comparative study between Mexicans and second and third generations of Mexican Americans' consumer patterns, diffusion processes and usage of reference groups. The published literature on Hispanics, and Mexican Americans in particular, could be used as a departing point to design this cross-cultural study.

The Diffusion Process

Consumers nowadays are confronted with an almost continuous process of decision making concerning the adoption of innovations. New products, new services and new concepts push one another to obtain consumers' attention and acceptance. The degree to which an individual adopts an innovation has to do with the innovation's particular characteristics, the adopter's profile and the environmental influences upon the decision-maker. The market has a higher probability of accepting a new product that is perceived as having advantages over existing products, is compatible with the values and beliefs of potential consumers, has a relatively low complexity degree, is easy to try, and when its benefits are easy to observe and communicate. (Hisrich, 1991). However, the socioeconomic characteristics, personality variables and communication behavior of potential customers have an important role in the degree to which an innovation becomes a success. These factors affect the stages of the Innovation Decision Process: knowledge, persuasion, decision, implementation and confirmation. (Schiffman and Kanuk, 1997).

During these stages, as the potential consumer becomes aware of the existence of the product, searches for guidance and evaluates alternatives, different sources of information become relevant. Among these, personal sources of information, or reference groups, play a fundamental role in the diffusion process. Understanding how individuals use reference groups can make it easier for marketers to communicate relevant information to potential consumers; thus facilitating the introduction process of innovations.

The concept of reference groups

"A reference group is any person or group that serves as a point of comparison (or reference) for an individual in forming either general or specific values, attitudes, or behavior". (Schiffman p.323)
The relevance people give to particular reference groups varies to a certain degree with their life cycle. During childhood, the family constitutes the most important source of information and establishes the foundation for values and attitudes. "Intra-family communication can influence brand preferences and loyalties, information search and examination patterns, media reliance, price sensitivity, and adherence to price-quality beliefs" (Rao, Childers, and Dutta, 1991, cited by Childers and Rao, 1992, p.199). However, as a child begins to grow, friends, social class, subcultures and culture as a whole, become salient.

Differences also occur when cross-cultural behavior is analyzed. For example, Childers & Rao (1992), found in an intercultural study comparing the importance of reference groups behavior between communalistic and individualistic societies, that family (vs. peer group), exerts a wider, stronger influence on the buying decision processes for consumers in Thailand than for consumers in the US. Furthermore, not all reference groups are considered worth of imitation by individuals, some are used as a criterion of what tastes, conducts, and attitudes to avoid. People are exposed to many groups during their lifetimes, but those groups, whose standards influence them seriously, become reference groups. "Consumer groups…are composed of people a consumer chooses to provide guidelines for his or her behavior; often, they are people with whom the consumer shares other background characteristics, such as cultural values, demographic subcultures, or lifestyles. Consumers choose those reference groups that provide them with the information, the power and resources, and the image they can use to complete the consumer purchase activities."(Wells, 1996, p.220)

Schiffman and Lazar Kanuk (1997, p.326) affirm that the degree of influence that a reference group exerts on the behavior of a person, is related to the information and experience possessed, to the credibility, attractiveness, and power of the reference group and the conspicuousness of the product. Low experienced individuals, when confronted with a decision making process will consult referents with the knowledge and expertise to help them make decisions. However, reference groups not only provide guidance and support, in certain situations they act as powerful enforcers of inner-group conformity. The person who belongs, identifies, or wants to belong to a group, must display choices and behaviors approved by the group in order to avoid rejection, or even punishment.

Kelley (1947) makes a distinction between "comparative reference groups" (those including public figures, like athletes and entertainment stars, who might not be personally known by an individual, but which establish standards), and "normative reference groups" (those in which family members, teachers and peers contribute to define norms, attitudes and values). Although comparative reference groups offer an interesting and important avenue of research, this study will limit itself to the analysis of the interaction between normative reference groups and its members.

Can differences in beliefs, attitudes and behaviors be attributed to national-cultural origins?

A large amount of published studies confirms this. Among them, I would like to use Hofstede's "Culture's Consequences" as a basis for analysis. In his impressive ecological study with a sample of 116,000 questionnaires, from 40 countries, in a lapse of 7 years, Hofstede confirmed theories established by other scientists and developed his own model to explain national-cultural differences. The author developed four indexes to use as the axes of his research: the Power Distance Index (related to Mulder's Power Distance Reduction Theory, 1976, 1977), the Uncertainty Avoidance Index, the Individualism Index, and the Masculinity Index. He analyzed the answers of the applied questionnaires to classify 40 countries in accordance with either high or low levels of conformity with respect to each of the indexes. Hofstede concluded that there were significant differences when measuring country responses for each of the four indexes, and developed clusters of countries with similar outcomes by index, and by indexes' combinations. For the purpose of this analysis I will only include the comparison between the results obtained by the US and Mexico. These results confirm that there are relevant national-cultural differences in three of the indexes (power distance, uncertainty avoidance, and individualism) between the two countries. There is not a considerable difference, when observing the values of the two countries with respect to the Masculinity Index. A table showing the values obtained per index by the United States and Mexico, and the value of the media of the 39 analyzed countries is presented next in Fig.1.

	POWER DISTANCE INDEX	UNCERTAINTY AVOIDANCE INDEX	INDIVIDUALISM INDEX	MASCULINITY INDEX
USA	40	36	91	62
MEXICO	81	86	30	69
MEAN OF 39 COUNTRIES	51	64	51	51

FIG. 1

How do Mexican-origin immigrants adapt to a culture, like the one in the US, which has a set of values so different from their own? Can reference groups help them to cope with the demands of their new reality?

The cultural dimension individualism-collectivism will be used as the basis for this study. Although the other two dimensions that show significant differences between the American and Mexican cultures (power distance, uncertainty avoidance), are certainly relevant, the scope of this analysis and the availability of published studies guided me towards the individualism dimension. Reference groups exist inside and outside of formal organizations, their informality allows them to flourish in the realm of social, personal relationships. Hofstede's findings related to the Individualism Index could be used also to understand processes that take place away of a working situation. When he describes the values of societies with low scores on individualism, like the Mexican society, he uses among others, the following findings: "In society, people are born into extended families or clans which protect them in exchange for loyalty. "We" consciousness. Collectivity orientation. Identity is based in the social system. Emphasis on belonging to organization; membership ideal. Organizations and clans to which one belongs invade private life; opinions are predetermined. Belief in group decisions." (Hofstede, 1984, p.171).

All these beliefs naturally agree with the usage of groups as sources of information, guidance and support. In summary, they agree with the usage of reference groups. It could be questioned if the author's findings from a survey of 1968 and another from 1972 are still valid. I would like to cite the results of two recently published studies, which validate Hofstede's findings. First, Dugan, Peterson and Leung (1998, p.259), showed in a study conducted among inhabitants of 23 countries, that Hofstede's cultural dimensions of individualism-collectivism and power distance continue to be highly valid after more than 20 years of having been generated. "The sources of this and several other recent studies in predicting and finding relationships between measures derived from Hofstede's data, which was collected in the sixties and early seventies, and data collected more than 20 years later, provides strong evidence for the durability of country-level cultural differences". In a second study, Merritt (2000), questions how applicable Hofstede's dimensions of national culture are, when used to analyze differences among commercial airline pilots flying in the 1990s. The author conducted a study that rendered significant replication correlations for all four of Hofstede's indexes, and concluded that: "The study confirms that the effects of national culture can be seen over and above the professional pilot culture…." (p.297).

Among other studies analyzing the effects that differences in national-cultural origins produce in beliefs, attitudes and behaviors, I would like to cite several that focus on the differences between collectivism and individualism: "In communalistic societies (which typically comprise extended families), individuals tend to identify more closely with their family than with outsiders, whereas the opposite would prevail in individualistic societies (which typically comprise nuclear families)" (Childers & Rao, 1992, p.199). "When people are guided by a socioemotional relational orientation, their effort and attention are directed toward the interpersonal climate of the situation, and they strive to maintain social harmony….for Latinos, emphasis on socioemotional aspects is compatible with efficiency and success." (Sanchez-Burks, Nisbett, and Ybarra, 2000, p. 174, p. 187). " … in collectivistic cultures, individuals tend to belong to a few select in-groups determined by membership in groups such as families and friendship circles, and the relationship of individuals to their in-groups tends to be stable over time" (Triandis, Bontempo, Villareal, Asia, & Lucca, 1988,). All these studies confirm Hofstede's conclusions, and point towards the relevance of the study, not only of differences between collective oriented and individualistic oriented cultures, but of the implications of the typical behaviors in the context of either type of culture.

Mexican Americans' cultural characteristics

Hofstede's research analyzes cultural differences between countries. However, Mexican Americans are a subculture within the US culture. Could it be valid to infer that the cultural trait of collectivism, characteristic of the Mexican culture, is also an important element in this subculture? Several authors have affirmatively answered this question. "The Mexican American extended family has been described as including: primary kin extended kin, and close friends and neighbors (Griffith & Villavicencio, 1985, cited by Patterson and Marsiglia, 2000, p.25). Mexican American and other Latino cultures stress cooperation, collectiveness, and strong intergenerational family ties" (Comas-Dilaz & Minrath, 1987; Harrison, Wodarski & Thyer, 1992; Smart & Smart, 1991; Smart & Smart, 1995, cited by Patterson and Marsiglia, 2000, p.25). At the center of this collective oriented cultural trait is the concept of the family. However, this is a much wider concept than the nuclear family concept prevailing in more individualistic cultures. Not only are distant relatives, of all ages, included in the family net, but close friends are incorporated into the family through different mechanisms. Godfathers and godmothers, by their participation in the baptism of a baby become emotionally entangled with the family for the rest of their lives. Moreover, not only them, but their family is also interwoven with the other family in this new social and emotional fabric. Neighbors or coworkers who have helped the family end being seen as part of it. So, the binding net of the family is extended. "The family is seen as a problem-solving unit that extends beyond blood relations. This kinship network encompasses a deep sense of obligation by its members to each other for economic assistance, encouragement, and support" (Gomez, 1987, cited by Patterson and Marsiglia, 2000, p.25)." Mexican Americans and other Latinos have also been found to rely on relatives more often than European Americans for emotional support and to regard familial support for emotional problems as superior to all others types of support" (Keefe, Padilla, & Carlos, 1979, cited by Patterson and Marsiglia, 2000, p.25).

When referring to Mexican Americans cultural characteristics, one must realize that a generalization is being made in assuming that even people who might share the Spanish language, some traditional family values, the catholic religion, and Mexican ancestors, are alike. One might find people showing different degrees of affiliation with respect to their subculture. People can be proud or disdainful of their origins. Deshpande, Hoyer, and Donthu (1986) found relevant differences among Mexican Americans levels of ethnic identification. The authors emphasize the need to use a "subjectivist" perspective of ethnicity, that is, one in which individuals describe their attitudes and the degree to which they feel as part of a subculture, instead of being included in it by the observation of demographic data, like race and surname. Following this line of thought Flores Niemann, Romero, Arredondo and Rodríguez (1999) published their study "What does it mean to be Mexican? In which they report the results of a qualitative research conducted among Mexican Americans concluding that: "People's social constructions of what it means to be members of their ethnic groups speak to their experiences and social realities. Results of this study indicate that for low-acculturated first- and second-generation US Mexicans and Mexican Americans, this reality is shaped by complex forces that include culture, aspects of ethnicity, and discrimination as well as realities that do not fit neatly into a given typology or organizational structure"(p.59). More in-depth analysis could contribute to a better understanding of the affiliation process, and the identification of similar consumer traits shared by members of a particular subculture.

Use of Reference Groups by Hispanics and Mexican Americans in Particular

The terms "Hispanics" and "Mexican Americans" are sometimes used in the literature as synonyms, but this is not accurate. In a paper published in American Demographics in 1993, the authors mention in the abstract, that "Hispanic Americans are a united market in some ways, but not in others. Those who share the same language, culture, religion, and television programs can be approached as a single market, but economic, political, and other differences divide the market into several distinct segments". Mexican Americans are a subgroup of a larger group; US Hispanics, which also includes people originally from Puerto Rico, El Salvador, Argentina and any other Spanish speaking country. Although the subgroup of interest for this study is the Mexican American, this section will use both terms when citing relevant literature. "In the process of the construction of social identities, the social groups that individuals compare themselves with are of crucial importance. Identity formation rests on the process of social comparison…." (Sümer, 1998, p.120). Hispanics, the same as other ethnic subcultures, use reference groups, especially normative groups like family and peers, to help them define who they are. This can be especially salient for minorities embedded in a powerful main stream culture, as the one in the US. As formal education and media are used by the main culture as tools to reach social homogeneity, members of minorities who do not identify themselves fully with the images of the main culture, may seek the advice and guidance of those nearer and more similar to themselves. Reference groups can also be used for pragmatic, more immediate purposes. The Journal of Advertising Research published in 1992 an interesting anonymous study, in which the specific buying and information gathering behavior of Mexican Americans was researched. The authors cite a study (Loudon and Della

Bitta, 1979), in which Hispanics are presented as fashion-conscious and gregarious, and having a tendency to buy brands that their parents bought. They concluded that: “Spanish-language Hispanics were found to have a significantly higher propensity to ask for product information from their family members and coworkers” (p.58). These behaviors reflect the Hispanics’ reliance on family members and peers, as reference groups, to satisfy a need for information and guidance.

Do Mexican Americans and Mexicans use Reference Groups in the Same Way?

In order to be able to answer this question, an initial answer should be provided to the question: Are Mexicans and Mexican Americans alike? The answer depends on whether Mexican Americans belong to a first, second, or subsequent generations. As Valentine explains: “With each passing generation, evidence suggests that Mexican Americans in the United States tend to assimilate more fully into the dominant society….” (2000, p.107). Factors like the geographical vicinity with Mexico and the increasingly lower costs of communication technologies between the two countries allow first generation migrants to keep in touch with their families, friends, and traditions on a frequent basis. It is a common practice for first generation migrants to travel to Mexico to celebrate Christmas at their hometowns; it is also common practice to send periodical amounts of money to family members left behind. But as families establish in a permanent way in the United States, and their children attend school and become fluent in the English language, their contact with America’s main stream culture affects them, and their identification with the Spanish language, and the beliefs and traditions of Mexico diminishes. Furthermore, Wallendorf and Reilly found that: “Contrary to the predictions based on the traditional model of assimilation, the results suggest that Mexican-American consumption patterns are not a simple blending of Mexican and Anglo patterns. Mexican-American consumption patterns indicate the emergence of a unique cultural style” (1983, p.198). This new subculture expresses itself in different behavior patterns. For example, Mexican Americans develop a way of speaking in which they mix words and language construction patterns of English and Spanish, in a way that it becomes difficult for English speakers or Spanish speakers to fully understand them. They also evolve from traditional Mexican food, adding to old recipes the ingredients commonly found in American food markets, thus creating a different “cuisine”. Therefore, an interesting possibility for future research would be to conduct a comparative study between Mexicans and second and third generations of Mexican Americans’ consumer patterns, diffusion processes and usage of reference groups. The published literature on Hispanics, and Mexican Americans in particular, could be used as a departing point to design this cross-cultural study.

Conclusions

Human behavior is sometimes difficult to understand, and almost always difficult to predict. It is Complicated by man’s gregarious nature. As groups develop, complex interrelations inside the groups, between different groups, and groups and individuals, become salient. From a Marketing point of view, the understanding of consumer behavior is essential. What motivates potential consumers to adopt an innovation, reject a new concept or recommend a new service? If the only answer to these questions were personal experience, reality would be simpler. However, others’ behaviors and opinions affect potential consumers, especially when this information comes from people who are relevant for the potential consumer. Therefore, the understanding of how reference groups are used by decision takers becomes important. Complexity increases when the cross-cultural dimension is added to the problem, and when Marketers become interested in a particular segment of consumers a deep analysis to understand what factors act as motivators is necessary. Ortega y Gasset, the Spanish philosopher, said: “I am myself and my circumstances”. This maxim may be useful to remember when studying cross-cultural consumer behavior. This paper constitutes an initial effort to understand the interrelationship between reference groups and a specific subculture, the Mexican Americans. The possibility to transpose these findings to the Mexican culture opens an interesting avenue for future research.

References

Contact the author for the list of references.

Human Capital Management in Malaysia: Preparing for Future Challenges

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Abstract

The economic growth and rapid industrial development has made Malaysia as one of the most open economies in the world. The last 30 years had seen the growth of industry particularly in the manufacturing sector plays a central role in the Malaysia's industrialization process. During the Fifth Malaysia Plan (1986-1990), the Industrial Master Plan (IMP) was launched, and the manufacturing sector was reorganized from a domestic-oriented sector to one export oriented.

Malaysia is striving to achieve an industrialized and developed nation by year 2020. The last thirty years (1970-1990) had seen the growth of industry particularly the manufacturing sector which is playing a central role in the nation's industrialization process. During the Fifth Malaysia Plan (1986-1990), the Industrial Master Plan (IMP) was launched, and the manufacturing sector was reorganized from a domestic-oriented sector to one export oriented. Together, the service sector and information technology sector are currently contributing to the economic development of Malaysia. Continuous strategic efforts and programs on industrial development, human resource development, business, government, education, economic and social strategies had been addressed, formulated, design and redesign and implemented in all facets of Malaysia Master Plans. The New Millennium sees Malaysia transforms from agriculture – based economy (1960s) to manufacturing or P-economy (1970s -1900s) and later transforms into knowledge-based economy or K-economy (2000- 2020).

The New Economy

In the New Economy, we foresee changes in our all works of life. This is mainly due to changing economic, social, political, and technology environment facing by the nation. In economic environment, issues relating to opportunity and threats of globalization, liberalization, WTO, AFTA and k-economy are deliberated at numerous meetings and dialogues. At the societal level, changes in values, work attitude and life styles, skill and educational requirement, changing demographic patterns of the work force increase complexity. At the same time, the political stability, the legislations, business rules and regulations, human rights and environmental policies in each nation and region are carefully analyzed by the investors to ensure their economic objectives are achieved. In the area of technology, the rapid development of ICT architecture and infrastructure contributes to the economic and business growth and social development. Malaysia is the case in point. This paper seeks to inform human resource management and development imperatives in attaining the national competitiveness in the New Economy.

For a newly emerging industrialized and fast growing economy like Malaysia, the human resource development policy is found to be an important agenda in the national master plan of the country. Issues relating to demand and supply of skilled labor, enhancement of workers' positive values, provision of relevant human resource training and education, creation of thinking and creative society and improvement of ICT literacy rates are important for economic growth and sustainable development in the competitive environment of the New Economy. Subsequently, the human resource development planning and strategies are formulated and action plan are outlined at various phases of development. The human resource imperatives related to supply and demand of productive, competitive and competent workforce for sustainable economic growth and development are addressed.

In any county, the industry culture differs among industries in terms of their specific environment such as the stakeholders, the degree of competition, the products and services produced, the types of markets (customers), the strategies, the types of technology used and ownership. Given such diversified and differentiated industry characteristics of each industry, each industry requires different and combined types of human resource management practices because of differences in job responsibilities, role, activities, expectations of results produced. In the case of manufacturing and service sector , it is perceived to be a "competitive business" environment that requires entrepreneurial philosophy and efficient production and management systems. Product and service quality, production and operation costs seem crucial to the financial performance of the firms. Thus, the strengths and weaknesses, threats and opportunities of the firms need to be analyzed and recognized giving the economic, political, technological and social development that have taken place. Thus, in a global business environment, the business competition requires " e-generation" managers, entrepreneurs and workers. Thus the human resource imperatives, i.e. supply of skilled and competent workforce, liberal organisation structure, productivity-based compensation systems, competency-based training and positive work culture and values are ways of achieving organizational and national competitive advantage in the New Economy.

In Malaysia, the two crucial issues with the quality of manpower are labor productivity and national competitiveness. The situation has prompted the government as well as the investors to turn to capital intensive projects and in turn creates a high demand for trained and skill workforce in science and technology, in particular. Hence human resource development is vital to the country's economic, industrial and technological development. The field of industrial relations is being called upon to give its best because the New Economy is predicted to be led by information and communication technology (ICT) and the role of human resource remains central.

Professional Labor Demand and Supply

Malaysia is a multiracial nation where the major groups comprised of Malays, Chinese and Indians. (See Table 1-3). The employment growth is presented in Table 4.

TABLE 1: POPULATION IN MALAYSIA YEAR 2000

Population (million)	**Bumiputra**	**Chinese**	**Indian**	**Others**
23.27	66.1%	25.3%	7.4%	1.2%

Median age (years) 23.9

Dependency Ratio

(the ratio of dependents to every 100 persons of working age)

59.1 percent

Source: Eighth Malaysian Plan (2001-2005)

TABLE 2: POPULATION AND AGE STRUCTURE 2000-2005 (MILLION PERSONS)

	2000	**2005**
Total population	23.27	26.04
Age Structure		
0-14	7.71	8.15
15-64	14.62	16.77
65 and above	0.94	1.12
median Age	23.9	25.3
dependency ratio	59.1%	55.3%

Source: Eighth Malaysian Plan (2001-2005)

TABLE 3: LABOUR FORCE AND EMPLOYMENT, 2001-2005 (‘000 PERSONS)

	2000	2005		Average Annual Growth 7MP	8MP
Total Labor Force	9572.5	11161.9		3%	3.1%
Local	8823.3	10591.9		3.6%	3.7%
Foreign	749.2	570		-2.6%	-5. 3%
Unemployment Rate	356	224.6			
Employment Rate	3.1	2.7			

Source: Eighth Malaysian Plan (2001-2005)

TABLE 4: EMPLOYMENT GROWTH RATE

Sector	**Average Employment Growth rate per annum during 8MP (2001-2005)**
Manufacturing Sector	4.6%
Service Sector	3.8%
Administrative & Managerial	6.9%
Production workers	2.0% (during the 8MP period)
Agricultural Workers	2.0% (during the 8MP period)
Service workers (tourism, hospitality, ICT, transportation	4.25 % per annum.

Source: Eighth Malaysia Plan (2001-2005)

Conclusion

In Malaysia, the composition of the work force has changed overtime because of factors such as equal opportunities and the growth of white-collar and service occupations. The significance of these changes is the impact they have on the work place, including the provision of equitable compensation. At the same time different people have different needs, and it is not easy to accommodate everyone. The challenge for management is working out what can be done to address the situation by meeting as far as practical, employee diverse needs. Contended that today employees are asking for more personal choices and additional benefits, a response to these changing needs has been the introduction of numerous innovative benefits.

All in all, the New - Economy and globalization have shown that the government, the private sector and the societal interests, concerns and reaction to the development of information technology and telecommunication. The development and the importance of production technology, information technology and telecommunication is reflected by the increased efficiency and productivity in the governmental systems, in the manufacturing, engineering and process industries and as well as in the financial and other service-related industries. In Malaysia, the rapid growth of industrialization and in information and telecommunication sector is not only changing the work-life of both the public and the private but also the life styles of Malaysian society.

References

Contact the author for a list of references.

Personalities Having Tolerance of Uncertainty

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Abstract

The purpose of this study is to find out which personalities have characteristics and attitudes which prefer entrepreneurship. Qualities which are measured are: Tolerance of Uncertainty, Willingness to Stand out from the Crowd, Wanting Harmony with Others, Believing in Destiny, and Having Control of one's Own Life. Personality is measured by Myers-Brigss Type Indicator. The sample consists of 283 business students. The results indicated, for example, that ENTP (extravert-intuitive-thinking-perceiving), ENTJ (extravert-intuitive-thinking-judging) and ENFJ (extravert-intuitive-feeling-judging) are high on risk-tolerance, whereas ISTJ's (introvert-sensing-thinking-judging) risk-tolerance is low. These risk-tolerant personalities would be potential as new entrepreneurs, so the education and the information of entrepreneurship should be directed especially to them. Personalities having low entrepreneurial qualities should be given more encouragement and different kinds of education of entrepreneurship in order to motivate them to see the possibilities of entrepreneurship.

Introduction

In Finland, as well as in many other welfare states, it is crucial to get new entrepreneurs on purpose to create new jobs. When trying to get new entrepreneurs, the educational system should take into account different personalities. Some personalities are by nature more inclined towards an entrepreneurial career, while others need more encouragement and maybe a different kind of educational support. Entrepreneurs' personality has been studied by some of the researchers and mostly the definitions such as novelty, risk, initiative and independence are included in the entrepreneurs' characteristics [5]. When considering successful entrepreneurs, they are typically considered personalities with aggressiveness, ambition, need for achievement and internal locus of control [see for example 11]. However, there are only a few studies which have been made of Myers-Briggs Type Indicator and entrepreneurs ([9], (10]). MBTI is one of the most used indicator when studying personality, and it has gained a strong position in organizational settings (teams, superior-subordinate relationships, organizational behavior etc.) ([2], [6], [7]) thus it is surprising that in research on entrepreneurs MBTI has not yet been very commonly used.

This study focuses on the personality of students and their entrepreneurial qualities concentrating on the Tolerance of Uncertainty, Willingness to Stand out from the Crowd, Wanting Harmony with Others, Believing in Destiny, and Having Control of One's Own Life. The purpose is to find out if there are connections with personality of students with these entrepreneurial characteristics. These entrepreneurial qualities are selected by reviewing earlier studies and partially applying Rotter's definition of the locus of control. Locus of control is one of the commonly used theories in entrepreneurship. With regard to the locus of control an individual can be seen as internal or external. An internal control expectation is usually associated with entrepreneurial characteristics [see e.g. short review 4].

Personality is examined here with Myers-Briggs Type Indicator (MBTI). MBTI includes 16 types, which are formed from 8 different bipolar preferences. These preferences are: Extraversion (E) - Introversion (I), Sensing (S) - iNtuition (N), Thinking (T) - Feeling (F) and Judging (J) – Perceiving (P). Extraverts focus primarily on people and objects whereas Introverts focus their energy on the inner world; concepts, ideas and internal experiences.

Sensing people concentrate on observable facts or happenings through one or more of the five senses whereas iNtuitives concentrate on meanings, relationships, and/or possibilities that have been worked out beyond the reach of the conscious mind. Persons who are more inclined to Thinking decide impersonally on the basis of logical consequences and Feeling persons decide on the basis of personal or social values. Judging people prefer decisiveness and closure, while Perceiving persons prefer flexibility and spontaneity. Each person is better user other bipolar preference than other; from these stronger preferences come up personality type that includes four-letter (preferences) [7]. Descriptions of each of the sixteen types are in Table 1.

Table 1: DESCRIPTIONS OF EACH PERSONALITY TYPES [8]

ESTJ	Realistic and practical, matter-of fact type. Likes to organize and manage.
ESTP	Quick in action. Enjoys everything that comes up. Likes action and mechanical things. Flexible and tolerant.
ISTP	Cool, looks at things from outside. Quiet and reserved. Logical, analyses things with humor.
ISTJ	Serious, quite and thorough. Good ability to concentrate; shows thoroughness.
ISFJ	Quiet, friendly, respectful. Good at taking all details into account. Loyal, considerate.
ISFP	Withdrawn, quiet and friendly, sensitive. Modest of ability. Does not like conflicts. Enjoys the moment, and tryies to avoid working with hurry.
ESFP	Enjoys company, approving, friendly. Enjoys everything and get others to enjoy everything as well. Likes action. Enthusiastic. Remembers more easily facts than theories.
ESFJ	Softhearted, talkative, popular, respectful. At his best in co-operation. Active member of committees.
INFJ	Persistence, individuality, and willingness to do everything necessary is the key to enable his success.
INFP	Full of enthusiastism and loyality, but does not speek before he knows one well. Likes to learn. Friendly, but not necessarily social.
ENFP	Warmly enthusiatic, lively, inventory. Has good imagination. Almost possible to do everything that is interesting to him.
ENFJ	Understanding, respectful. Takes others' feelings into account. Social, popular and sympathetic.
INTJ	Individual. Wants his own ideas and projects. Has an ability to organize work. Sceptical, critical, independent and sometimes stubborn.
INTP	Quite and reserved. Enjoys theoretical and scientific goals. Solves problems logically and analytically. Mainly interested in ideas, but not so much interested in social life.
ENTP	Quick, inventory, good at plenty of things. Straight and ready to act. Likes challenges, but dislikes routines.
ENTJ	Strong will, straight and decisive. Manager of activities. Sometimes more selfassured than earlier experience would demand.

Methods

Sample

The sample included 283 business students of the University of Vaasa. There were some more males (50,9%) than females. As regards personality type, most of the respondents were ESTJs (20,9%), ENTJs (13,1%), ISTJs (9,9%) or

ESFJs (9,9%). The rarest types in the sample were INTJs (1,4%), ISTPs (1,4%) and INFJs (1,8%). The distribution of personality types and preferences in the sample is illustrated in the Table 2.

Table 2: THE DISTRIBUTION OF PERSONALITY TYPES AND PREFERENCES IN THE SAMPLE

Note: ■ = 1% of sample. Print date: 5.9.2003

■ ■■■■■■■■■■ ■■■■■■■■■■ % = 20.85 N = 59 **ESTJ**	■■■■■■■■■■ % = 9.89 N = 28 **ESFJ**	■■■■■■■■ % = 8.48 N = 24 **ENFJ**	■■■ ■■■■■■■■■■ % = 13.07 N = 37 **ENTJ**
■■■■ % = 3.89 N = 11 **ESTP**	■■■■ % = 3.53 N = 10 **ESFP**	■■■■■■■ % = 6.71 N = 19 **ENFP**	■■■■■■■■ % = 8.48 N = 24 **ENTP**
■ % = 1.41 N = 4 **ISTP**	■■ % = 2.47 N = 7 **ISFP**	■■ % = 2.47 N = 7 **INFP**	■■ % = 2.47 N = 7 **INTP**
■■■■■■■■■■ % = 9.89 N = 28 **ISTJ**	■■■ % = 3.18 N = 9 **ISFJ**	■■ % = 1.77 N = 5 **INFJ**	■ % = 1.41 N = 4 **INTJ**

N = 283

	N	%
Fdom	66	23.32
Tdom	107	37.81
Ndom	52	18.37
Sdom	58	20.49
ES	108	38.16
IS	48	16.96
EN	104	36.75
IN	23	8.13
FJ	66	23.32
FP	43	15.19
TP	46	16.25
TJ	128	45.23
NJ	70	24.73
NP	57	20.14
SP	32	11.31
SJ	124	43.82
NT	72	25.44
NF	55	19.43
SF	54	19.08
ST	102	36.04
EJ	148	52.30
EP	64	22.61
IP	25	8.83
IJ	46	16.25
P	89	31.45
J	194	68.55
F	109	38.52
T	174	61.48
N	127	44.88
S	156	55.12
I	71	25.09
E	212	74.91

Whole data

Instruments

In the questionnaire, the characteristics and attitudes towards entrepreneurship were measured by 14 items. These items concerned respondents' thoughts, for example, new ideas, changes, risks and willingness to stand out. From these items five factors (Varimax) were obtained: Tolerance of Uncertainty, Willingness to Stand Out from the Crowd, Wanting Harmony with Others, Believing in Destiny, and Having Control of one's Own Life. All of the factors had adequate reliability ranging from 0.49 (at Control of one's Own Life) to 0.67 (at Tolerance of Uncertainty).

Tolerance of Uncertainty contains items such as "I am afraid of taking risks", "In my experience the changes will mean only problems" and "I am often so unsure, that I can not act". In the Willingness to Stand out from the Crowd, the topics were for example "I do not want to stand out from others with my personal thoughts or ideas", " I do not tell my craziest ideas to others". In these matters, high ratings of the responses of the respondents mean low tolerance of uncertainty and low willingness to stand out from crowd.

The third factor Wanting Harmony with Others, is described with questions such as "If I want to succeed, I should not irritate other people", "If I want to get my plans to function, I make sure that they suit others' wishes as well. The Believing-in-Destiny factor contains for example convictions like: "My things go as they are going", "It is a question of destiny, how I will manage in life". The last factor; Having Control of one's Own Life, contains the beliefs such as "I can, mostly, decide myself what will happen to me in this life", and "I try to get my ideas to function, even if there would be resistance from other people".

Personality was measured using the Finnish research version form F of the Myers-Briggs Type Indicator (MBTI). The construct validity and reliability of this Finnish research F-version of MBTI has been proved during a validation process of several years [see e.g. 3]. According to Järlström [3] the internal consistency (Pearson's correlation coefficients) was .65 to .76 and (Cronbach's coefficient alpha) was .79 to .86.

Results

When looking at the personality and the different characteristics the following results occurred (see Table 3). The significant differences (at level 0.001) occurred in Tolerance of Uncertainty and Willingness to Stand out from the Crowd (post-hoc results in Table 4).

According to the Post-hoc tests the significant differences occurred in Tolerance of Uncertainty between ISTJ with ENFJ; ISTJ with ENTP and ISTJ with ENTJ. ISTJ was among those who had the weakest capability to handle the uncertainty. With ISTJ there was also other introvert types among the four weakest in this factor: INTJ, INFJ and ISFJ. Most capable to handle the uncertainty were these three extraverted types: ENTP, ENFJ and ENTJ, among them the ENFP also had high results in this field.

The Post-hoc test indicated that the significant differences in Willingness to Stand Out from the Crown, were between ESTJ and ENFP; ISTJ and ESTJ; ISTJ and ENFJ; ISTJ and ENFP; ISTJ and INTP; ISTJ and ENTP and finally ISTJ and ENTJ. The most Willing to Stand Out were types INTP, ENFP, ESTP, ENFJ and ENTP. Among the lowest in Willingness to stand out were INTJ, ISTJ, ISTP, ISFJ and ESTJ.

Even if there were no significant differences in the other three parts, some guiding information can be gained from these results. In the Wanting Harmony with Others, the lowest were ISFPs and ENFPs. The types who most wanted harmony were ESFJ, ISTJ, ISTP, ESTJ, ENFJ and INFJ. The types mostly Believing in Destiny were ISTP and ISFJ. The weakest belief in destiny had ENTP and ESFP. Having a sense of Controlling one's Own Life had mostly ENFJ, ISFP and ENTJ. Weakest sense of Controlling of one's Own Life was with ISFJ and ISTJ.

Table 3: OVERALL RESULTS (NOT SIGNIFICANT)

	High	Low
Tolerance of Uncertainty	ENTP, ENFJ, ENFP, ENTJ, ESTP	INTJ, INFJ, ISTJ, ISFJ
Willingness to Stand out from the Crowd	INTP, ENFP, ESTP, ENFJ, ENTP	INTJ, ISTJ, ISTP, ISFJ
Wanting Harmony with Others	ESFJ, ISTJ, ISTP, ESTJ	ISFP, ENFP, INTP, ESTP, ENTJ, INFP
Believing in Destiny	ISTP, ISFJ, INFP, INFJ	ENTP, ESFP, ISFP, ENFP
Having Control of one's Own Life	ENFJ, ISFP, ENTJ, ESFJ	ISFJ, ISTJ,INFJ, INFP

Table 4: RESULTS OF THE POST-HOC ANALYSES

Tolerance of Uncertainty (sig. 0.000)	
ISTJ < ENFJ	p. <0.05
ISTJ < ENTP	p. <0.05
ISTJ < ENTJ	p. <0.05
Willingness to Stand out from the Crowd (sig. 0.000)	
ESTJ< ENFP	p. <0.05
ISTJ < ESTP	p. <0.05
ISTJ < ENFJ	p. <0.05
ISTJ < ENFP	p. <0.01
ISTJ < INTP	p. <0.05
ISTJ < ENTP	p. <0.01
ISTJ < ENTJ	p. <0.01

Conclusions

These results indicated that certain personality types have by nature qualities, characteristics and attitudes that have been regarded as essential to entrepreneurs. Even if statistically significant results occurred in two areas of the questionnaire, some tendencies can be seen from other parts as well. ENTP, ENFJ, ENFP, ENTJ and ESTP are types that have high Tolerance of Uncertainty. Four of them were extraverted-intuitive (EN) types who are action-oriented innovators [7]. These types might be so used to action, that the steady moments get them to feel bored and some amounts of uncertainty will only make their lives more exciting. Willingness to Stand out from the Crowd was shown by types INTP, ENFP, ESTP, ENFP and ENTP. They are all perceiving (P) types, who are spontaneous, flexible and adventurous. Not necessarily wanting harmony, but being what they are, were types such as ISFP, ENFP, INTP, ESTP, ENTJ and INFP. Most of them were again perceiving types, except ENTJ. Types who were not believing in destiny were ENTP, ESFP, ISFP and ENFP types. Again they were all perceiving types.

ENFJ, ISFP, ENTJ and ESFP were types that thought that they have control of their own lives. In this part they were also judging types. Judging types want to control their schedule, like routines, and are not so flexible as perceiving types.

In the light of these results the most potential new entrepreneurs are types like ENFP, ENTP, ENFJ, ENTJ, ISFP and INTP. They are more extraverted, intuitive, thinking and perceiving types than their counterparts. Extraverted people like to be in action, intuitives are good at "hunches" and having new ideas, thinking types are logical and rational, and perceiving types are flexible, independent and capable of taking risks [8]. It may be mentioned, that perceiving types are overrepresented among prisoners too [1].

ENFPs and ENTPs are quite near to each other and so are ENFJs and ENTJs as well. The only difference is preference thinking/feeling. ENFJs and ENTJs are more managerially oriented because of their skill to organize. It has been said that ENTJs are born managers; this can be seen in their high amounts among the managers ([7], [8]). ENFPs, ENTPs and INTPs appreciate individuality and they have a high need of independence. These may be their main reasons to start own their company, whereas ENTJs and ENFJs are most probably attracted by entrepreneurship because of their high ambition. ISFPs like to do concrete things and like independence as well, thus they most probably start first small, for example handicraft companies.

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The Impact of the Values of Top Managers upon their Subordinates' Values

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Abstract

Psychologists, sociologists, economists, management scholars, as well as other researchers from other disciplines have been attempting to find answers to two fundamental questions: how to make workers appreciate the methods used to manage/lead them; and how to induce them to act in their owners, managers/leaders favour. One key factor, which has been talked about, is values and especially shared values. If the employees and their managers have common/shared values the working together would be at least emotionally easier.

Introduction and background of research problem

Intensive global competition, higher customer expectations and greater focus on quality have resulted in much greater requirements placed upon employees today than decades ago (Quinn and Spreitzer 1997). This pressure may seem especially high for employees from former soviet countries, because these demands are fundamentally different to those made under the Soviet regime. During this period the soviet state was responsible for guaranteeing work for everyone and so enterprises were internally overstaffed and passive and work places were over-secured (Liuhto 1999: 16). According to Edwards and Lawrence (2000), the emergent change to processes in transforming countries can only be truly understood by examining the constitutive practices of individuals and groups at the local micro levels of the economic system. Research in countries going through transformation has shown that the transfer of knowledge from market-economy practices often fails because of institutional and cultural tensions and conflict (Clark and Geppert 2002).

The research problem is, how values held by managers influence their subordinates' commitment, effectiveness and satisfaction. A conceptual framework for the study will be presented followed by the results of empirical study in Estonian companies.

The post-communist transformation provides settings, which are in the process of being demolished, that are very different in their characteristics and within which discontinuities are more fundamental and change is less constrained by institutional frameworks. In this paper transformation has been seen as a social process of fundamental political, economic and cultural change to structures and values at all levels of society. Therefore the author applies institutionalism in order to understand the behaviour of organisations.

Estonia, the smallest of Baltic states, had practiced democracy and market economy and enjoyed living standards comparable to the Scandinavian nations already before unlawful incorporation into Soviet Union in 1940 (Zamascikov 1978). Although wages, income, housing and productivity in Baltic republics were higher than in the rest of European republics of SU (Gregory 1987). Soviet occupation had brought significant decline in the standards of living (Misiunas 1983). Soviet regime was successful in eliminating private enterprise but what did not disappear was a dim sense of having lost something valuable. This sense was anchored in a Protestant work ethic that was much more deeply rooted than Lutheranism itself and was felt to be part of the besieged national culture (Taagepera, 1993).

Estonia was a forefront of reforms in SU. Radical reforms in Estonia started in 1987-88 when a group of theoreticians and practitioners debated the idea of economic autonomy for Estonia. In 1990 an important change occurred in the strategic aim of the reforms in Estonia: economic autonomy was replaced by independent statehood and the restoration of a market economy. The transition to a market economy was supported by the re-establishment of independence in august 1991.

The process of economic reform was radical and quick. The beginning of 90-ies was the serious decline in the Estonian economy, GDP declined about 14% in 1991, 18% in 1992 and 2% in 1993. In 1994 GDP finally started to grow (Rajasalu 1995).

Research results from Estonian organisations indicate that this specific environment during the Soviet era had an impact on peoples' value system. A survey of values conducted in the second half of the nineties indicated that Estonian business students underestimated social values when compared with Finnish students (Ennulo and Türnpuu 2001). These researchers found this typical for representatives of post-socialist countries in comparison with representatives from countries without a socialist experience (ibid. 342).

The research problem is, how values held by managers influence their subordinates' commitment, effectiveness and satisfaction. A conceptual framework for the study will be presented followed by the results of empirical study in Estonian companies.

Theoretical bases

In the introductory speech of 10th Chemintz East Forum which was titled The End of Transformation (2003) professor R. Lang proposed the model to describe, how society influences individual values during transition in Central and East Europe (Figure 1).

Transformation has been described as social transience – a process, in which a complex set of normative and operating principles, embodied in historical structures, systems and practices becomes replaced by another unknown set, providing its members with a very ambiguous and uncertain period (Clark and Soulsby 1999:18).

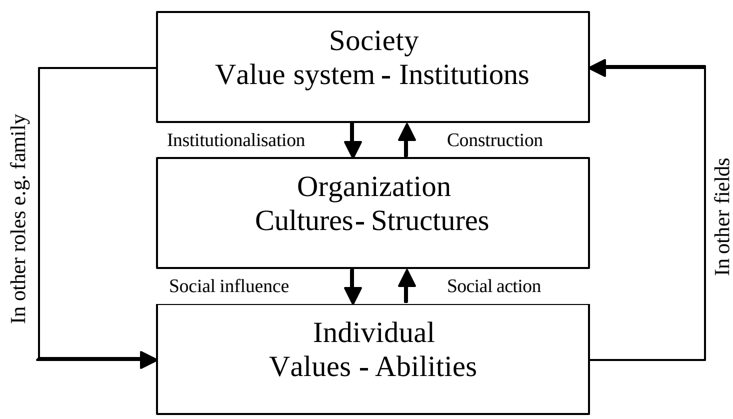

FIGURE 1 DIFFERENT LEVELS OF TRANSFORMATION OF VALUES. SOURCE: LANG 2003.

According to the institutional perspective, the functioning of organisations can be described using the open-system approach, in which the organisation may be seen as answering the challenges of a new environment. Institutions find expression in society through social constructions: formal institutions at the macro level in a market economy include private property and the free market; formal institutions at the micro level are organisations. Individual organisations are under the technical and normative influence of institutionalised environments.

Institutions could be seen from both the structural and social perspective. From the structural viewpoint institutions exist as institutionalised forms of 'external social constraints'. From the social perspective institutions can be understood as operating to enforce behavioural definition, which may take the form of either 'cultural accounts' or 'cultural rules'. This means that institutions are accounts of how the social world works and embody normative principles and social values (Meyer et al 1994:24).

Socio-economic transformation, at both macro and micro levels, could be understood as institutional change, from both the structural and social perspective, embracing both structures and social values. The elements of an institution may lose credibility and need redefining – the processes of *deinstitutionalisation* and *reinstitutionalisation* take place.

From this institutional view, social transformation may be interpreted as the period between the effective demise of one institutional system and the point at which another institutional system has been established and accepted on new cognitive and normative grounds. Such circumstances create acute social and psychological problems for the social actors and this period has been called *social transience* (Clark and Soulsby 1999:40).

According to social scientists, behaviour is a function of the meaning of a given situation. Participants in social events bring to them prior meanings and stereotypes, which can be understood only in a historical and cultural context (Sahlins 1985). Organisational climate and culture scholars have been concerned with how the sense-making process, the filtration, processing and attachment of meaning in organisations, occurs (Schneider 2000). Sense-making is an emergent process (Weick 2001) and is to some extent institutionalised.

The history of research into organisational culture is the history of how a field dominated by scholars steeped in psychology and sociology has learned from cultural anthropology (Ashkanasy et al 2000). Discourse about organisational culture has come to be about the way an organisational context shapes the meanings and actions of organisational members.

In cross-cultural management studies term ‘Culture’ is used as an explanatory variable to explain the differences between employee behaviours and attitudes as well as management practices. Generally, culture is used by social scientists to refer to a set of parameters that differentiate collectives from each other in meaningful ways. Collectives thus differentiated are regarded as distinct cultures (House et al, 1996).

Management is the process of getting things done through (other) people. In order to manage, one has to know “the things” that must be done and one has to know the people who have to do it. Understanding people means understanding their backgrounds – from which present and future behaviour can be predicted. A useful way to look at people in organisations is in terms of the socialisation they have received before joining the organisation and the socialisation they receive at work. Differences in socialisation explain why equally gifted persons will act quite differently in a given situation. In the socialisation process, four elements of culture are transferred (from superficial to deep) symbols, heroes, rituals and values (Pucik et al 1993: 140).

Values are “constructs representing generalised behaviours or states of affairs that are considered by the individual to be important (Yukl 2001: 133). In work-place settings values can affect decisions about whether to join an organisation, organisational commitment, relationships with co-workers, and decisions about leaving an organisation. It is important for leaders that it be possible for individuals in the same working unit to have considerably different values, especially since values cannot be seen directly, but only inferred on the basis of people’s behaviour (Yukl 2001: 134).

Values represent the deepest level of culture. They are broad feelings, often unconscious and not discussible, about what is good and what is evil, beautiful or ugly, rational or irrational, normal or abnormal, natural or paradoxical, decent or indecent. These feelings are present in most of the members of a culture, or at least in those persons who occupy pivotal positions (Pucik et al 1993: 141).

According to Milton Rokeach, a leading researcher into values, a value is “an enduring belief that a specific mode of conduct or end-state of existence is personally or socially preferable to an opposite or converse mode of conduct or end state of existence.” Rokeach (1973) defines an individual value system as an “enduring organisation of beliefs concerning preferable modes of conduct or end-states of existence along a continuum of relative importance. Rokeach divided values into instrumental and terminal values. Instrumental values are alternative behaviours or means by which we achieve desired ends (terminal values). Terminal values are end-states or goals the individual would like to achieve during his/her lifetime, basically, what life is all about.

Managers have to be aware of three types of value conflict in themselves and their co-workers – intrapersonal, interpersonal and individual-organisation value conflict (Pucik et al. 1993: 143).

While values represent global beliefs that influence behaviour across all situations, attitudes relate only to behaviour directed toward specific objects or situations. An attitude is defined as “ a learned predisposition to respond in a consistently favourable or unfavourable manner with respect to a given object. Attitudes tend to be consistent over time and across related situations. Values and attitudes are generally in harmony, but not always. Because our cultural backgrounds and experiences vary, our attitudes and behaviour also vary. Attitudes are translated into behaviour via behavioural intentions (Pucik 1993: 143).

According to Massey (1979), each person's values reflect contributions made by diverse inputs, including family, peers, the education system, the media, science and technology, geography and current events. Although one's values can change throughout one's life, they are relatively firmly established by young adulthood.

Ashkanasy (2000) writes that one issue of major concentration in the values literature has to do with distinction between values (in the general sense) and work values – a concept that implies the existence of particular sets of values that govern employee work behavior, in all of its forms. Most conceptions and definitions of work values are consistent of most general definitions of values in the broader sense, but they focus on work, work behavior and work related outcomes.

GLOBE research project specifies connections between societal culture and organizational culture.

Gobe research project

In Calgary in 1994 at the international meeting of Globe Country Co-Investigators, and based on the discussion and deliberation of 84 social scientists and management scholars representing 56 countries, a definition of leadership was formulated as follows: 'Leadership is the ability of an individual to influence, motivate, and enable others to contribute toward the effectiveness and success of the organisation of which they are members' (House et al. 1996).

The specific criteria used to differentiate collectivities (cultures) usually depend on the preferences of the investigators and the issues under investigation, and tend to reflect the discipline of the investigator. For the GLOBE research program culture was defined as the common experiences of individuals, which result in shared motives, values, beliefs, identities, and interpretations (meanings) of significant events (House et al. 1996).

For the purposes of the GLOBE research programme, culture is operationally defined as the use of measures reflecting two kinds of cultural manifestations:

a) The commonality (agreement) among the members of the collectivity with respect to the attributes (values, beliefs, etc) of culture.
b) The commonality of observed and reported practices by entities such as families, work organisations, economic and legal systems and political institutions.

The theoretical basis that guides the GLOBE research is an integrated construct of several theories. A diagram of this integrated theory is presented in Figure 2.

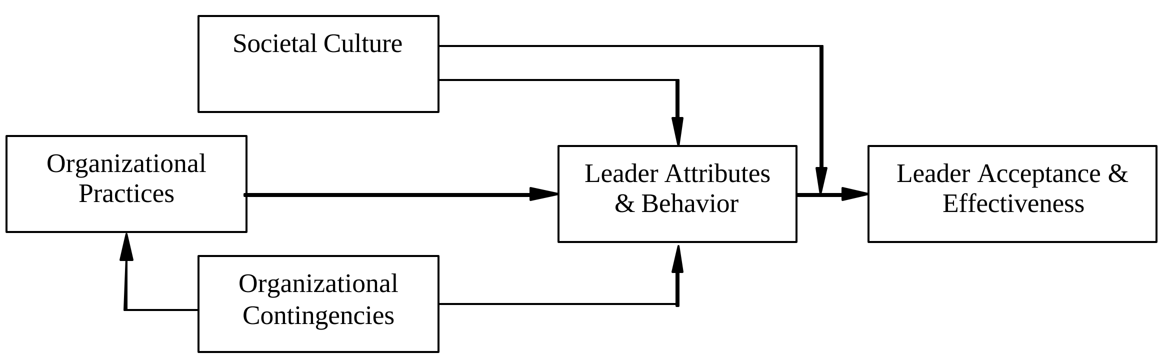

FIGURE 2:HEORETICAL MODEL OF RESEARCH. SOURCE: HOUSE ET AL. 1996: 6.

The integrated theory consists of the following assertions:

1) Cultural values and beliefs provide incentives, cues, guidance, constraints and reinforcements for selected behaviours and practices.
2) The implicit motives that are stressed in the culture result in the differential social learning of implicit motives by members of the culture.
3) Jointly, the dominant cultural values, beliefs, assumptions, and implicit motives endorsed by cultures give shared meaning to leader attributes and behaviour and organisational practices. They provide meaning in the sense that selected behaviours and organisational practices are understood in a particular way in each culture.
4) The shared meaning, values, beliefs and motives take on the status of norms, which are socially learned, communicated, and enforced by members of the culture. These norms are cultural level variables that guide individual behaviour and the evaluation of such behaviour.

According to Koopman (2002) the result must, where Central and Eastern Europe is concerned, be placed in the context of recent history. Their results provide some evidence that preferred leadership styles vary according to culture. Clusters of European countries that share similar cultural values were shown to also share similar leadership prototypes (Brodbeck et al. 1999).

The Empirical Study in Estonian Organizations

The authors formulated the following research questions:

1) Do managers/leaders have common, that is, shared values with their subordinates?
2) Are the values of subordinates related to the motivation of subordinates?
3) Are the values of managers/leaders values related with the motivation of subordinates?

During the second half of 2001 Estonia (and the author of this article) joined phase II of the Cross Cultural CEO Leadership Study carried out by Robert J. House and his colleagues of the Global Leadership and Organisational Behaviour Effectiveness Research Program (GLOBE). GLOBE is a long-term project directed toward the development of systematic knowledge concerning how societal and organisational cultures and subcultures affect leadership and organisational practices.

The design of the Cross Cultural CEO project required 20 CEOs from entrepreneurial firms and 20 CEOs from non-entrepreneurial firms or larger organisations. Heads of divisions in domestic companies were not considered CEOs and did not qualify to be included in the sample.

In 2001 more than 60 companies were visited. Complete research kits, including interviews, CEO questionnaires and all the required questionnaires for subordinates (2 from type c, d, e), were returned from 40 companies. This data was sent to the University of Pennsylvania for further investigation related to the subject of cultural differences and leadership. More than 240 questionnaires were completed by subordinates in addition to the 40 questionnaires completed by the CEOs.

The study involved interviewing the CEOs; the interviews were recorded on audiotape and transcribed onto written protocols. Questionnaires were also administered to at least those subordinates immediately below the chief executives.

30 % of the data gathered during the field research did not meet the requirements of the Cross Cultural CEO project. The main reason for this was that some of the questionnaires distributed to the subordinates did not come back.

Results

Connections that were discovered between the values held by managers and the values and motivation of their subordinates were in some cases interesting, in some cases predictable and in some cases confusing.

Firstly, a cluster analysis of the values was conducted and based on this the values could be divided into four major groups as follows:

a) values related to the welfare of society;
b) values related to the short-term welfare of the organisation;
c) values related to the long-term welfare of the organisation;
d) values related to religion and supernatural powers.

Results according to received clusters are shown in Table 1.

TABLE 1. CLUSTERS OF VALUES

Cluster	Value	Mean CEOs	Std. Deviation	Mean Subord.	Std. Deviation
Welfare of Society	Economic welfare of the nation	4,15	1,04	3,99	1,24
	Economic welfare of the local	4,33	1,11	4,14	1,17
	community	3,61	1,47	3,67	1,35
	Effect on female employees	3,12	1,30	3,20	1,40
	Effect on minority employees	**3,80**		**3,75**	
Long term welfare of the organisation	Employee relations (well-being, safety, working conditions)	5,18	0,10	5,28	1,04
	Effect on relationships with other organisations	5,07	0,82	5,07	0,97
	Effect on the environment	4,53	1,12	4,30	1,25
	Ethical considerations	5,09	1,16	5,05	1,28
	Employee professional growth and development	5,18	0,85	5,28	1,02
	Effect on long-term competitive ability of the organisation	5,6	0,86	5,43	1,07
		5,11		**5,07**	
Short term welfare of the organisation	Effect on product quality	5,59	1,09	5,77	1,04
	Effect on sales volumes	5,33	1,06	5,49	1,48
	Effect on firm profitability	5,73	0,89	5,56	1,13
	Cost control	5,31	1,01	5,31	0,94
	Customer satisfaction	5,96	1,23	6,09	0,96
		5,58		**5,64**	
Religion	Pleasing, respecting, not offending a divine being (god, idol)	2,44	1,62	2,30	1,43
	Effect on supernatural forces	1,54	0,91	1,58	1,06
		1,99		**1,94**	

Note: the scores are given on scale from 1 to 7

The most important values for the CEOs of Estonian companies were values related to short-term welfare (on the seven-point scale m=5,58) followed by long term welfare values (m=5,11) and those related to the welfare of society (m=3,8). Least important were values related to religion (m=1,9).

When we compared the mean values of the two groups – managers/leaders and their subordinates – it turned out that their rating of the importance of values in each group was practically the same. The fact that there is no difference is theoretically a good grounding for establishing leader acceptance and effective outcomes.

The result of the comparison of managers and subordinate values are shown in Table 2.

TABLE 2. VALUES SHARED BY SUBORDINATES AND THEIR MANAGERS/LEADERS

Values of Subordinates	Values of Managers	
Cost control	Effect on the long term competitive ability of the organisation	0,223
Values of Subordinates	Values of Managers	
	and business, for example suppliers, government agencies, strategic alliances	
Customer satisfaction	Employee professional growth and development	0,213
	Effect on the long term competitive ability of the organisation	0,167
	Effect on the environment	0,146
Employee relations issues such as employee well-being, safety, working conditions	Effect on the long term competitive ability of the organisation	0,195
	Employee professional growth and development	0,175
	Employee relations issues such as employee well-being, safety, working conditions	0,165
Contributions to the economic welfare of the nation	Contributions to the economic welfare of the nation	0,322
	Employee relations issues such as employee well-being, safety, working conditions	0,211
The welfare of the local community	Contributions to the economic welfare of the nation	0,232
	The welfare of the local community	0,210
	Employee relations issues such as employee well-being, safety, working conditions	0,183
Employee professional growth and development	Employee professional growth and development	0,250
Pleasing, respecting, not offending a divine being - a god or an idol for example	Pleasing, respecting, not offending a divine being – a god or an idol for example	0,197
Effect on the environment	Effect on the environment	0,189
	Contributions to the economic welfare of the nation	0,158
Ethical considerations	Employee professional growth and development	0,174
	Ethical considerations	0,167
Effect on firm’s profitability	Effect on firm’s profitability	0,207
	Effect on the long term competitive ability of the organisation	0,189
Effect on product quality	Ethical considerations	0,225
	Customer satisfaction	0,193
	Effect on the long term competitive ability of the organisation	0,184
	Employee professional growth and development	0,180
	Effect on firm’s profitability	0,153
Effect on sales volume	Effect on firm’s profitability	0,24

For answer to the first research question – Do managers have common or shared values with their subordinates? – the following correlations were found. The most significant connection was the shared values concerning *contributions to the economic welfare of the nation* (r = .322). This was followed by *employee professional growth and development* (r = .250) and then *the welfare of the local community* (r = .210).

In adittion to the previous question about shared values we investegated how the managers/leaders were perceived by their subordinates. And as a result we can say that, in Estonian context we can not talk about leadership yet. At the moment, Estonian CEOs are characterised as managers. The subordinates see them as directive information sources (see Table 3), but do not yet see them as leaders.

TABLE 3. HOW SUBORDINATES PERCEIVE THEIR MANAGERS

Perception	Mean	Perception	Mean
1. Directive	5,53	5. Shows self-confidence Administratively	5,24
2. Information Source	5,45	6. Effective	5,24
3. Communicator	5,35	7. Follower Confidence	5,24
4. Visionary	5,30		

Note: The scores given are on a scale from 1 to 7

While conducting research into the values held by subordinates and their levels of motivation (2) the following observations were noted. Satisfied customers and high sales volumes are the things that motivate personnel the most. One reason for this could be that their monthly salary or bonus is directly connected with sales (r= .251) and sales figures are definitely related to the existence or non-existence of satisfied customers (r= .250). It is also logical that when product quality (r= .231) is taken as a motivator there cannot be satisfied customers or high volume sales if the goods sold are of an unacceptable quality (See Table 4).

TABLE 4. CONNECTIONS BETWEEN VALUES HELD BY SUBORDINATES AND THEIR MOTIVATION LEVEL.

Values held by subordinates	r	Values held by subordinates	r
1. Customer satisfaction	0,251	7. The welfare of the local community	0,172
2. Effect on sales volume	0,250	8. Effect on the long term competitive ability	0,168
3. Effect on product quality	0,231	9. Employee professional growth and development	0,162
4. Effect on female employees	0,191	10. Cost control	0,151
5. Effect on relationships with other organisations	0,179	11. Effect on the firm's profitability	0,151
6. Contribution to the economic welfare of the nation	0,177	12. Ethical considerations	0,150

One interesting thing that was proven as the result of this research was that values held by managers are practically not connected to the motivation levels of their subordinates at all. There was only one value held by managers that was in positive correlation with the motivation of their subordinates and that was – *Effect on relationships with other organisations with which you do serious business* – for example suppliers, government agencies, strategic alliances (r = .161). However, even this connection was quite low.

When we analyse the values held by managers and the way they are perceived by their subordinates we find many connections. In Table 5 the most important connections can be seen and from them it seems that most of the correlations are related to the value attributed to cost control by managers. This could be related to the fact that at the moment, after ten years of experience with a free market economy, we have reached that turning point where the efficiency and final result of a company does not depend so much on sales but on cost control. If we go back to Clusters of Values (see Table 1) and look what was important for the CEOs of Estonian companies – values related with the short term welfare of the organization where belongs also cost control. Cost control is perceived by subordinates as autonomous autocrat who has to be at least diplomat to get things done or can be described by integrity. CEO is not perceived as humane or power sharing or charismatic person. As we discussed before Estonians are not jet seeing values behind short-term effects, what cost control definitely is, and may be we even do not need charismatic, future oriented leaders jet but diplomatic managers are enough and which is useful also in process of doing business with other organizations

When talking about being ethical, then a manager even if he/she is still not a leader has to be fair which is perceived also by the subordinates while economic welfare of the nation is related with the fact of being communicative and human person.

TABLE 5. THE VALUES HELD BY MANAGERS AND THEIR SUBORDINATE'S PERCEPTION OF THEM

	r>0		r<0
Cost Control			
Autonomous	0,258	Humane	0,298
Autocratic	0,216	Power Sharing	0,295
Integrity	0,208	Charismatic effects	0,272
Diplomatic	0,165	Fair	0,253
		Information source	0,239
		Inspirational	0,228
		Administratively effective	0,221
		Non contingent praise	0,208
		Communicator	0,203
		Follower confidence	0,186
		Decisive	0,184
		Visionary	0,182
		Shows self-confidence	0,174
		Status conscious	0,173
		Face saver	0,169
		Directive	0,165
		Intellectually stimulating	0,158
		Role clarification	0,156
Contribution to the economic welfare of the nation			
Decisive	0,275	Autonomous	0,302
Communicator	0,217	Diplomatic	0,267
Humane	0,189	Malevolent	0,237
		Power sharing	0,203
		Integrity	0,196
		Autocratic	0,189
		Role clarification	0,162
Ethical considerations			
Fair	0,163	Autocratic	0,208
		Integrity	0,240
		Power sharing	0,148
		Role clarification	0,188
Effect on the long term competitive ability of the organisation			
		Status conscious	0,209
		Intellectually stimulating	0,202
		Team oriented	0,156
Effect on relationships with other organisations with which you do serious business			
Diplomatic	0,203	Indirect	0,346
Bureaucratic	0,248		

Conclusions

The most important values for the CEOs of Estonian companies during transition period from centrally planned economy to free market economy were values related to short-term welfare followed by long term welfare values and those related to the welfare of society. Least important were values related to religion.

This kind of rating of values is probably connected with the fact that during the period of transition the main aim of the management of companies is to ensure short term results – profit – achieved by sales and cost control. When talking about sales we need a satisfied customer and this is achieved via quality products.

After the short-term welfare of an enterprise, of course, comes the long-term welfare. To provide a continuous, long-term competitive advantage new variables such as employee relations, inter-organisational relations, environmental protection and ethical aspects gain importance.

When we draw some parallels with results of World Value Survey (Inglehart 1998) we can also see the fact that Estonians are interested in short tem results as for example salary and they do not have "dreams" about working hard. The issue of belief has also the same result in World Value Survey as in our research.

When we compared the mean values of the two groups – managers/leaders and their subordinates – it turned out that their rating of the importance of values in each group was practically the same. The fact that there is no difference is theoretically a good grounding for establishing leader acceptance and effective outcomes.

The current study indicates that managers' values do not have a direct impact on subordinates' motivation during transition from centrally planned economy to free market economy in Estonian society. But managers' values influence subordinate motivation through mediating variables. Managers' values are transferred to subordinates and those values held by subordinates correlate with subordinate motivation. Also, values held by managers have an impact on the perceptions subordinates have about their managers and these perceptions correlate with subordinate motivation. Also the subordinates' own value estimations influence their perception of their superiors, which in turn, influences subordinate motivation.

The main conclusion of this research is that values held by Estonian leaders do not affect subordinate motivation directly, but indirectly through the values held by their subordinates and how their subordinates perceive their leaders.

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Victim and Non-Victim Responses to Anti-Bullying Practices

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Abstract

Despite many tragic events resulting from workplace bullying, there has been little empirical research on identifying means to eradicate it. Research has focused primarily on measuring the frequency of workplace bullying and on recommending individual and organizational anti-bullying practices. Whether or not these strategies work, however, is unknown. This paper examines the perceived effectiveness of organizational and individual responses to bullying from both the victim's and non-victim's perspective. Results suggest that victims (as opposed to non-victims) are more likely to perceive that the bullying climate in their organization is tolerant and that passive individual responses to bullying (e.g., doing nothing) are less harmful than more active responses (e.g., reporting it). Victims also appear to be less confident that practices such as zero-tolerance programs and anonymous hotlines (i.e., practices widely encouraged) are effective anti-bullying strategies. The results presented are drawn from a large survey sample as well as several in-depth interviews.

Introduction

Workplace bullying is generally defined as the intentional and repeated unpleasant behavior of an individual onto another, less powerful individual [25]. Bullying includes verbal and physical behaviors ranging from hurtful teasing, taunting, humiliation, and physical aggression. Some of the most common bullying behaviors include intimidating, excluding, setting impossible deadlines, belittling and angering subordinates [21]. Bullies engage in four types of bullying behavior [21]: 1) they bully by intimidating, criticizing and being rude; 2) they bully through the work and deadlines they have assigned; 3) they bully by engaging in childish behaviors such as teasing and mimicking; and, 4) they bully using physical means.

There are many other terms used to describe worker mistreatment, such as violence [5], aggression [24], abuse [20], tyranny [3], incivility [8], deviance [12, 32], antisocial behavior [13], harassment [10, 11] and dysfunctional behavior [16]. Bullying can be distinguished from other forms of mistreatment by considering three important criteria. First, there must be an imbalance in power between the bully and their victims (e.g., a boss has legitimate, reward and punishment power over his subordinates). Secondly, the unpleasant behaviors must occur repeatedly over time (a behavior that occurs only once is not considered bullying). Lastly, the behavior must be intended to do harm (e.g., repeatedly yelling at your employee in front of his/her peers is intended to embarrass).

Although the last couple of decades of research on bullying has been limited to school-age children and schoolyard bullying [2,6,7,15,17,25,27,31,35], interest and research on workplace bullying is growing rapidly. This is partly due the organizational and social costs associated with bullying as well as the extensive media attention of tragic events (e.g., such as the shooting rampage of Pierre Lebrun at OC Transpo [22].) Because research on workplace bullying is still in its infancy, empirical research on workplace bullying has focused primarily on measuring the frequency of workplace bullying and on identifying the possible causes of workplace bullying. There is much variance in reported frequencies. For instance, research conducted in Danish workplaces reported that approximately 2% of all employees are bullied at work [19]. Another study reported that 8.8% of European business professionals are bullied "once in a while'' and 1.6% are bullied on a weekly basis [33]. Yet another study conducted in the UK reported that as large as 53% of employees felt that they had been bullied at work at some time in their life [29]. A recent Canadian study reported that about 16% of all subjects reported being bullied at least on a monthly basis and about 6% reported being bullied at least on a weekly basis [21]. However, when provided with a list of what is generally considered to be bullying behaviors, about 58% indicated that they had endured at least one of these behaviors on a monthly basis and 25% indicated that they were victims of at least three of these behaviors per month.

Because bullying is intended to do harm, it is not surprising that victims are more likely to be stressed and suffer from stress-related symptoms, such as decreased productivity, decreased satisfaction and increased absenteeism [5]. Bullying has a direct effect on the organization's bottom line and as a consequence there is abundant advice on how to tackle workplace bullying in the literature [9,11,18,19,30]. For instance, bullying can be prevented by conducting reference checks prior to hiring, establishing codes of conduct, providing assertiveness/sensitivity training and adopting zero-tolerance policies. Bully bosses can be identified by introducing anonymous hotlines, investigating areas with high turnover and absenteeism, and conducting exit interviews. Bullying can be stopped by disciplining bullies and giving HR greater power to act on bullies. Victims are advised to document the transgressions, practice assertiveness and seek outside help. Many organizations have incorporated this advice by adopting zero-tolerance policies, providing employees with diverse means to report transgressions and giving the Human Resources department more power to investigate and discipline workplace bullies.

Despite the abundant advice given to organizations, little is known about how effective these organizational and individual practices are in managing, reducing and eliminating bullying, however. Further, it is unknown if victims and non-victims perceive the effectiveness of these practices similarly. The purpose of this research is therefore to examine how both victims and non-victims perceive the bullying climate of their organization and the effectiveness of individual and organizational anti-bullying practices.

Methodology

Sample

The final sample consisted of 474 subjects (36% male) ranging in age from 18 to 60 years (mean = 24.2 years, s.d. = 5 years). Twenty-one percent of all subjects were members of a visible minority group and 76% were single. Participants were asked by a research assistant to participate in a study about bullying at the beginning of evening undergraduate classes at the School of Management, University of Ottawa. Students were informed that participation was voluntary and that their responses were anonymous and confidential. The response rate was 71 percent. Only surveys completed by participants who were currently working at least 20 hours per week were retained for the study. The questionnaire took about 15 minutes to complete.

Respondents were also invited to provide their contact information if they wished to participate in a follow-up in-depth interview. Thirty-seven subjects (7.6%) indicated that they would like to be interviewed and provided their name and contact information. Of the thirty-seven, fifteen were interviewed (the others could not be reached or had changed their minds). Subjects were asked to talk about their latest bullying incident and to describe what had happened and how they had reacted. The interviewer did not interject except to ask prompting questions such as "what did you do next?" and clarifying questions such as "could you be more specific?" The interviews were tape-recorded and transcribed. Each interview lasted about twenty minutes.

Measures

The survey consisted of four sections. The first section measured the frequency with which subjects had been bullied at work by their bosses. Subjects were provided with a definition of workplace bullying and were asked to indicate how often they had been bullied. Bullying was defined as the "*intentional and repeated unpleasant behavior of an individual onto another less powerful individual*"**.** Subjects were asked to rate the frequency of bullying by checking one of five choices; daily, weekly, monthly, yearly or never. Following this general question, subjects were asked to indicate how frequently they were victims of thirty-four more specific bullying behaviors. These bullying behaviors were compiled from an extensive review of the literature that strictly dealt with bullying [1,4,10,11,15,29,30]. Sample items include '*my boss intimidates me,*' '*my boss physically harms me*' and '*my boss sets unrealistic or impossible deadlines for work.*' These too were rated either daily, weekly, monthly, yearly or never. Although there is some variance in the literature about how frequently bullying has to occur to be considered bullying, most authors agree that bullying on a monthly basis is the minimum. We chose to use this standard as well. Therefore, if a subject indicated that he/she was bullied (according to the definition) at least once a month, he/she was considered to be a bully victim, resulting in a victim sample of 76 (16% of the sample). The remaining 398 were classified as non-victims (note that skewed samples are typical in research on violence and that the skewed nature should be considered when interpreting results). The number of bullying acts a victim was subjected to on a monthly basis was used to measure the frequency of bullying. The second section of the survey assessed the bullying climate of the subject's organization. Subjects were asked to indicate the extent to which they agreed or disagreed with ten statements describing their organization's tolerance and reaction to bullying. Sample items include '*my organization condemns bullying,*' '*it is useless to file complaints*' and '*bullies are punished for their actions*'. Items were combined to form a Bullying Tolerance Climate scale and was highly reliable (Cronbach Alpha=.82). The third section of the questionnaire was designed to assess the perceived effectiveness of a variety of anti-bullying strategies. Subjects were asked to evaluate effectiveness using a five-point scale (1-make things a lot better, 2-make things somewhat better, 3-make no difference, 4-make things somewhat worse, 5-make things a lot worse). The first sixteen items focused on individual (i.e., victim) anti-bullying practices; the subsequent 19 items focused on organization level anti-bullying practices. Items were based on a list of anti-bullying recommendations cited in the literature [14,15,19,20,23,26]. The last section collected demographic data such as age, gender, marital status, visible minority status, years of employment, hours worked per week, and employment sector.

Results

Victim and Non-Victim Perceptions of their Organization's Bullying Climate

Victims and non-victims perceive their organization's attitude towards bullying very differently (see Table 1). Victims were significantly more likely to disagree that their organization condemned and punished bullying than non-victims (BULLYING TOLERANCE CLIMATE, F=104.39, p<.001). In fact, on average, non-victims slightly agreed that the bullying climate of their organization was one that did not tolerate bullying (mean=3.15, s.d.=0.8). Although it is possible that all the victims were employed at more tolerant organizations and that non-victims were employed at less tolerant organizations, it is more likely that victims and non-victims perceive their organizations differently. Victims also indicated that they were less comfortable filing complaints (F=34.93, p<.001); as a consequence, victims may be less likely to report bullying or discuss their concerns with their employer.

TABLE 1- VICTIM AND NON-VICTIM PERCEPTIONS OF ORGANIZATION'S BULLYING CLIMATE

Perception of Bullying Climate	Non-Victims Mean	s.d.	Victims Mean	s.d.	F
The organization I work for condemns bullying	3.58	1.3	2.70	1.3	27.88
Bullies are punished for their actions	3.20	1.2	2.36	1.2	31.11
Senior management is indifferent to my complaints	2.37	1.2	3.24	1.2	33.44
The human resources department is indifferent to bullying	2.34	1.1	3.18	1.2	34.68
I feel comfortable about filing a complaint	3.34	1.4	2.34	1.3	34.93
There is no point in me filing complaints	2.27	1.3	3.32	1.5	40.89
I would fear that I might be blamed if I were to admit I was bullied	1.96	1.1	3.08	1.4	58.02
No actions are taken against bullying	2.04	1.2	3.11	1.3	50.28
I would not fear any repercussions if I were to bully another worker	1.91	1.2	2.37	1.3	9.25
Bullying is accepted by my organization	1.60	1.0	2.63	1.3	58.56
BULLYING TOLERANCE CLIMATE	3.15	0.8	2.24	0.7	104.39

Note: 1-Strongly disagree, 2-somewhat disagree, 3-neither agree nor disagree, 4-somewhat agree, 5-strongly agree; all significant to p<.001.

Perceived Effectiveness of Organizational Responses to Bullying

Victims and non-victims also differ in the way they evaluate the effectiveness of a variety of organizational anti-bullying strategies. Table 2 provides the top ten most effective anti-bullying strategies as perceived by non-victims (the rank that each strategy received among victims is included in rightmost column). Table 3 parallels Table 2 and lists the top ten anti-bullying strategies from the victim's perspective. Bolded items indicate that the perception of the effectiveness of those strategies that differed significantly between victims and non-victims. Both victims and non-victims indicated that they believed that the most effective means of responding to bullying was to provide a clear communication of an anti-bullying climate (e.g., the organization should make it clear that bullying is not tolerated, new employees should be notified that bullying is not tolerated) and to provide greater resources and power to the human resources department (e.g., human resources should have the needed tools to address bullying). Note that the top three anti-bullying strategies are the same for both victims and non-victims. The major difference between victims and non-victims was in the way they evaluated specific programs designed to tackle bullying. Non-victims felt significantly more strongly than victims that practices such as Zero-Tolerance Programs ($F=14.6$, $p<.001$) and Anonymous hotlines ($F=18.8$, $p<.001$) were effective. These programs are widely recommended in the literature as critical to the success of bully-free climates. If victims are weary of them, however, it is unclear if these programs are reaching their intended audience and if other means are needed. Non-victims also felt significantly more strongly than victims that a more direct approach (i.e., bully bosses should be told that their behavior is unacceptable) was appropriate ($F=4.00$, $p<.05$).

TABLE 2: ANTI-BULLYING PRACTICES EFFECTIVENESS: NON-VICTIM'S PERSPECTIVE

Top Ten Perceived Most Effective Anti-Bullying Practices (Non-Victim)	Mean	s.d.	Rank Victim
1. The organization should make it clear that bullying is not tolerated	1.52	0.72	3
2. Human resources should have the needed tools to address bullying	1.54	0.66	2
3. New employees should be notified that bullying is not tolerated	1.57	0.73	1
4. Bully bosses should receive supervisory training to build their people skills in order to prevent bullying	1.70	0.75	6
5. Bully bosses should be told that their behavior is unacceptable	**1.71**	**0.85**	**9**
6. Human resources should give more importance to addressing bullying	1.73	0.70	5
7. Exit interviews should be conducted in order to find out why people have quit their jobs	1.75	0.74	4
8. Zero-Tolerance Workplace Bullying System	**1.76**	**0.73**	**11**
9. An anonymous hotline to report bullying incidents	**1.78**	**0.77**	**17**
10. Performance evaluations should be conducted in order to detect bullying	1.81	0.76	10

Note: 1-make things a lot better, 2-make things somewhat better, 3-make no difference, 4-makes things somewhat worse, 5-make things a lot worse

TABLE 3: ANTI-BULLYING PRACTICES EFFECTIVENESS: VICTIM'S PERSPECTIVE

Top Ten Most Perceived Effective Anti-Bullying Practices (Victim)	Mean	s.d.	Rank (Non-Victims)
1. New employees should be notified that bullying is not tolerated	1.64	0.76	3
2. Human resources should have the needed tools to address bullying	1.65	0.70	2
3. The organization should make it clear that bullying is not tolerated	1.68	0.89	1
4. Exit interviews should be conducted in order to find out why people have quit their jobs	1.74	0.71	7
5. Human resources should give more importance to addressing bullying	1.76	0.71	6
6. Bully bosses should receive supervisory training to build their people skills in order to prevent bullying	1.79	0.82	4
7. Give more freedom to human resources for dealing with bullying	1.89	0.62	12
8. Bosses should be rewarded for treating their employees fairly	1.92	0.95	13
9. Bully bosses should be told that their behavior is unacceptable	**1.93**	**1.04**	**5**
10. Performance evaluations should be conducted in order to detect bullying	1.93	0.81	10

Note: 1-make things a lot better, 2-make things somewhat better, 3-make no difference, 4-makes things somewhat worse, 5-make things a lot worse

Non-Victim and Victim Responses to Bullying

Table 4 summarizes how victims and non-victims evaluate the benefit of a variety of bullying responses. The first column provides the mean difference between the evaluation of victims and non-victims; a negative score indicates that victims feel that the reaction is less harmful than do non-victims, a positive score indicates the reverse. On the one hand, victims believed that passive strategies such as staying away from work ($F=15.79$, $p<.001$), keeping quiet ($F=7.43$, $p<.01$), and laughing it off ($F=5.00$, $p<.05$) was significantly more effective in dealing with bullying than did non-victims. On the other hand, non-victims felt that more vocal and pro-active measures, such as finding other people who are bullied in order to gather evidence (4.55, $p<.05$), putting the bully on notice that his/her actions will not be tolerated ($F=4.49$, $p<.05$) , discussing the situation with others (e.g., lawyer, $F=6.00$, $p<.05$); colleagues, $F=6.78$, $p<.05$; and Human Resources, $F=25.71$, $p<.001$) and fighting back ($F=3.93$, $p<.05$), were significantly more effective.

The victim's belief that passive reactions to bullying is more effective (or less harmful) is also correlated with the frequency of abuse. Victim's experiencing more abuse were more likely to report a preference for staying away from work ($r=-.15$, $p<.001$), keeping quiet ($r=-.16$, $p<.001$), laughing it off ($r=-.10$, $p<.05$) and avoiding the place where bullying happens ($r=-10$, $p<.05$). At the same time, they were less likely to document the behaviour ($r=.12$, $p<.05$), gather other evidence ($r=.12$, $p<.05$) or discuss it with others (lawyer, $r=.11$, $p<.05$; colleagues, $r=.13$, $p<.001$; HR department, $r=.25$, $p<.001$). In fact, discussing the matter with the HR department produced the greatest discrepancy between victim's and non-victim's evaluation.

TABLE 4 – VICTIM AND NON-VICTIM RESPONSES TO BULLYING

Bullying Response	Mean diff. btw victim & non-victims	F-test	Correlation with frequency of bullying(R)	Victim Mean(s.d)	Non-Victim Mean(s.d.)
Stay away from work	-.59	15.79***	-.15**	3.30 (1.3)	3.89 (1.2)
Keep Quiet	-.43	7.43**	-.16**	3.11 (1.2)	3.54 (1.2)
Laugh it off	-.33	5.00*	-.10*	2.80 (1.1)	3.13 (1.1)
Avoid place where bullying happens	-.21	2.43	-.10*	2.42 (1.0)	2.63 (1.1)
Do nothing	-.18	2.29	-.08	3.70 (1.0)	3.88 (1.0)
Retaliate	-.08	0.33	-.02	3.91 (1.0)	3.99 (1.2)
Talk your way out of situation	.00	0.01	-.02	2.92 (1.2)	2.92 (1.1)
Make threats to quit	.00	0.01	-.01	3.37 (0.9)	3.37 (0.9)
Go see a doctor	.04	0.17	.01	2.80 (0.7)	2.76 (0.8)
Document the behaviour	.18	2.94	.12*	2.06 (1.0)	1.88 (0.8)
Find other people that are bullied in order to gather evidence	.24	4.55*	.12*	2.44 (1.0)	2.20 (0.9)
Put the bully on notice that his/her actions will not be tolerated	.28	4.49*	.09	2.37 (1.3)	2.09 (1.0)
Go see a lawyer	.32	6.00*	.11*	3.11 (1.1)	2.79 (1.0)
Discuss it with colleagues	.32	6.78*	.13**	2.72 (1.0)	2.40 (1.0)
Fight back	.33	3.93*	.06	3.45 (1.3)	3.12 (1.3)
Discuss it with human resources department	.58	25.71***	.25**	2.52(1.1)	1.95 (0.9)

Note: 1-Make things a lot better, 2-Make things somewhat better, 3-make no difference, 4-make things somewhat worse, 5-make things a lot worse

To further shed light on how victims respond to bullying, responses from the follow-up interview study were summarized. When subjects were asked to describe how they reacted to a bullying incident, they responded as follows:

1. "I kept doing this broken record technique and stating that this was coming sort of unexpectedly and that this was an inappropriate time to discuss it and that I wasn't prepared to talk about it and that if they'd like to schedule another time where we could sit down and talk further about it that I'd be happy to do it."

2. "Well I focussed on doing my job and I was looking for something else because I know that I was in a no-win situation. My motivation originally was that if I could just keep doing things really excellent and achieving the results that they were looking for, I'd have to win them over eventually but it was just never going to happen."
3. "I would just click into a mode of thinking that this had really nothing to do with me, it had to do with other issues."
4. "I would keep a sense of humour about it. I would picture them like cartoon characters with an axe in their head."
5. "My philosophy is that we are all put here to get along so find a way to get along. If it means bending or if it means biting your tongue or if it means a lot of things, then do them."
6. "At one point the I said that I was going to go smoke because I couldn't take it anymore. I punched the metal door on the way out."
7. "It used to really upset me but it got to the point where now I just don't say OK and go on because I know it's not personal."
8. "So what I have to do is that I have to be very careful of the way I say things to him. I have to be very careful because he's always on his defensive and he's always afraid of being attacked and he lies."
9. "And I'm at the point where I can't anymore. I've had several bullying situations and I've tried to settle these situations but it hasn't changed anything. So at the point where I'm at I prefer to leave."
10. "It was one of these situations where I was really young and foolish and thought I was responsible. So I actually had never told anybody."
11. "If we see her coming down the hall we just pick up the phone and pretend that we're calling someone. Or we say that we are really busy and don't have time to talk about this, you know. Or just hope that someone call for you at that moment when she walks in the office."
12. "I had spoken about the problem with the general manager and I had explained to her how it was impossible to talk with him. She tried talking with him but the only thing that happened is that he'd act all nice and so she wouldn't understand why the employees were complaining. Now for them we were just complainers."
13. "I've tried going to the manager of human resources but that did nothing. She believed the supervisor. They were supposed to put up meetings and stuff to try to fix the situation but the employers are nice for a week after and then they go back."
14. "So we look out for each other. If he walks in and starts talking about somebody then another person will make a comment telling him, well you know, 'look there are friends among us, keep your mouth shut.'"
15. "So my reaction was to yell even louder and to swear at him in front of the clients. He called his assistant so that she could continue to supervise while we went to finish our discussion in his office. We fixed our differences and everything was OK."

Of the fifteen interviews, eleven engaged in some form of avoidance behaviour, two indicated that they had tried unsuccessfully to get help from outside their department, one indicated that the victims reacted by forming alliances with another and one last victim responded in kind (i.e., bullied back). Clearly the literature's recommendations are not working as intended.

Discussion and Conclusions

These results suggest that victims perceive that outside help, such as HR, could (or would) not help them with their bully boss. This means that even if the organization were equipped with a variety of anti-bullying programs and practices, it is unclear if they would reach their intended audience; that is the victims themselves! Also, these results suggest that non-victims believe that they would deal with bullying in a more active and assertive way (and more in line with the literature). Evidently, experience with bullying changes this opinion. Clearly, a new approach to help victims is needed.

It may not be realistic for organizations to enforce a zero-tolerance anti-bullying policy or to remove the bully. One reason for this is that workplace bullies are frequently very successful and productive employees; they get the job done. Consequently, little motivates employers to remove these individuals. Further, successful bullies frequently occupy positions of power and are inherently 'fireproof''. Bullying occurs too frequently and its costs are too high to be ignored, however. Shifting the emphasis to training victims to better cope with and handle their bully boss is a practical alternative and would give employees the tools needed to better manage their daily lives.

Although research on workplace bullying is relatively recent, research on schoolyard bullying is much more extensive. It is well documented that children find it difficult to tell an authority figure that they are being bullied. Consequently, training school children to cope with bullies has existed for at few decades. Some of the most common advice is summarized in Table 5[2,6,7,15,17,25,27,31,35].

Parallels to the workplace setting can be easily made. Employees can be provided with assertiveness training. More opportunities to form teams, alliances, clubs and friendships should be provided; there is 'power in numbers' in organizations too. Being able to 'tell someone' should be reiterated, especially to those who may have lost faith in human resources. Finally, it may be helpful for employees to know that it may be easier to cope with a bully boss by keeping a sense of humor about it (note that one of our interviewees used this as a coping mechanism), empathizing with the bully (e.g., my boss is under pressure), walking away or giving them what they want; at least until the bullying situation is remedied through other means.

TABLE 5 - COPING STRATEGIES FOR SCHOOLYARD VICTIMS

1. Practice assertive body language (e.g., walk tall).
2. Develop self-confidence (e.g., through sports).
3. Form friendships, join clubs (power in numbers).
4. Tell someone.
5. Assert yourself verbally (e.g., say NO).
6. Use "I" statements to personalize the demand (e.g., I don't want to do this).
7. Use humor as a counter-attack.
8. Walk away, don't fight back.
9. Give them what they want.
10. Remember that bullies have feelings too.

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A Comparison of Communication Satisfaction and Organizational Commitment among Public and Private Sector Employees in Malaysia

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Abstract

This study focuses on the relationship between organizational communication satisfaction and organizational commitment in public and private organizations in Malaysia. Data were collected using the Downs's (1990) Communication Satisfaction Questionnaire and Organizational Commitment Questionnaire by Meyer and Allen (1990). A total of 319 respondents from private sector and 309 respondents from public sector were involved in the study.

Results of this study indicated that there exists an explicit positive relationship between communication satisfaction and employees' organizational commitment. Also, there is evidence of significant differences in terms of communication satisfaction among public and private employees. Based on the set of results, this study highlights the importance of recognizing that communication satisfaction which are multi-dimensional. Each dimension may affect organizational commitment differently.

Introduction

The importance of communication in the functioning of any organization is well established. Bernard (1938) refers to communication as the "nerve system" of the organization. Organizational communication has been studied from different perspectives with relative success in producing theoretical model that can help us to have better understanding of its nature and functions. Over the past two decades, the construct of communication satisfaction and organizational commitment have been the important variables of interest to organizational communication researchers (Clampitt & Downs, 1987; Putti, Aryee, & Phua, 1990) and yet few studies have focused directly on the relationship between these two organizational variables.

Problem Statement

People communicate to satisfy interpersonal needs, which, in turns, influence their communication choices and behaviors (Rubin & Rubin, 1992). In essence, then, people have motives for communicating. Since communication practices and organizational commitment attitudes are important processes in organizations, there is a need for the study of there two dimensions within organizations. Moreover, there is a need to study the relationship between these two variables in the context of public and private sector. A review of literature reveals that in fact there is a lack of research on the relationship between communication satisfaction and organizational commitment. Therefore, the relationship that is believed to exist between these two variables is more implied than demonstrated. On the other hand, the study of the relationship between communication satisfaction and organizational commitment is particularly important since it is believed that the implication of the findings of such research may have a significant impact on managerial activities and organizational effectiveness.

In order to fulfill this need for studying the relationship between communication satisfaction and organizational commitment, a major thrust of research has been recently initiated by Downs (1989). The purpose of this new research trend in organizational communication is to examine the relationship between communication satisfaction and organizational commitment in various cultures. The Potvin (1991) study in the United States and the Downs (1991) study in Australia were two of the first reported studies of research in this area. The present study, which has studied the nature of the relationship between communication satisfaction and organizational commitment in Malaysia, is part of this research thrust.

The purpose of this study is also to review some of the many arguments about the differences (and similarities) between public and private organizations in Malaysia. It is not always clear, however, how these differences are attributable to differences in the personnel systems -and attendant rewards and sanctions- of the respective sectors or whether the people who choose to work in the private sector are, as a whole, somewhat unlike those choosing to work in the public sector (Bozeman, 1989).

Communication Satisfaction

The term “communication satisfaction” was first introduced by Level (1959) in his analysis of human communication in an urban bank. Redding (1978) reported that the term communication satisfaction has been used “to refer to the over-all degree of satisfaction an employee perceives in his total communication environment.” A relatively new and successful research stream in organizational communication (Crino & White, 1981) has attempted to conceptualize and operationalize a construct labeled communication satisfaction by Downs and Hazen (1973). The construct of communication satisfaction has become an accepted part of the organizational communication literature over the last 20 years (Clampitt & Downs, 1987). Many studies have been built on the Downs – Hazen Communication Satisfaction Questionnaire and those have resulted in the creation of a new and successful research stream. The findings of the various studies revealed that: 1) the construct of communication satisfaction is multidimensional; 2) the Communication Satisfaction Questionnaire has proven to be a useful tool for organizational diagnosis in a wide range of organizations; 3) communication satisfaction links to the end-product variables of job satisfaction and productivity, and 4) the communication satisfaction construct is effective in explaining job satisfaction and productivity (Clampitt & Downs, 1987).

Organizational Commitment

Organizational commitment has been of more recent interest to organizational communication researcher over the past two decades (Putti, Aryee & Phua, 1990). This interest in commitment stemmed from its demonstrated linkafe with variables that had an influence on organizational effectiveness such as absenteeism, turnover and job performance. According to Putti, Aryee, and Phua (1990), most of these studies about the antecedents and consequences of commitment focused primarily on structural, individual, and role-related variables (Mowday, Porter & Steers, 1982). As a consequence, the organizational processes have been ignored as potential determinants of commitment. One such organizational process is communication and the members’ satisfaction with communication relationships (Putti, Aryee, & Phua, 1990).

Commitment is an attitude or behavior, although Mowday, Porter, and Steers (1982) suggest both are linked in that each reinforces the other. Buchanan (1974) defines commitment as an employee’s adoption of the organization’s values (identification), involvement (psychological immersion) and loyalty (affection/attachment). Others see commitment as the extent to which employees (a) contribute to the organization’s well being (Mowday, Porter, & Steers, 1979), (b) share in managerially promoted organizational images (Tredwell & Harrison (1974), or (c) are partners in a social exchange idea in that each giver to other (Eisenberger, Fasolo & Davis -LaMastro, 1990).

In 1990 the effective and continuance commitment subscales (Meyer & Allen, 1984) were supplemented by the normative subscale (Allen & Meyer, 1990; Meyer & Allen, 1991) to form the three-aspect concept of organizational commitment. Three main issues have emerged concerning the subscales. First is the reliability and uni-dimensionality of the subscales. Second, significant correlations between the subscales suggest they are not independent dimensions of commitment. Third, the dominance of the affective component in terms of effects.

McGee and Ford (1987) questioned the structure of the affective and continuance factors in their study of 350 faculty members from Canada and the United States. Factor analysis identified four factors, three with loadings over .40. The items for continuance commitment loaded on two separate factors. Correlations between these factors and the affective factor were significant and signed opposite for each factor in contrast to weak correlations when the single continuance factor was examined by Meyer and Allen (1984).

In other research, the three subscales were found to have high reliability and supportive factor analysis (Ward & Davis, 1995; Benkhoff, 1997) although, because of the level of correlation between the affective and normative commitment subscales, questions have been raised about their uni-dimensionality (Allen & Meyer, 1990; Shore & Wayne, 1993). Using a revised normative commitment scale, Meyer, Allen, and Smith (1993) identified an unexpectedly strong correlation with affective commitment that could not clearly be linked to revisions in the scale or to the sample context. One possible explanation is that as employment has generally become less secure over the last decade or so, normative commitment has become less related to principles and more dependent on levels of affective commitment.

In summary, although the Meyer and Allen commitment scale shows promise in their measurement of organizational commitment, the form of commitment expressed by factors and the independence of the constructs are not clear. Meyer, Allen, and Gellatly (1991) indicated that the three-component model may not represent a unitary construct or include the only relevant components of commitment. However, in their later examination of construct validity of the scales, Meyer and Allen (1996) argued that sufficient research evidence exist to support the use of three factors based on the scale even though it is not clear that the continuance commitment scale is a uni-dimensional construct.

Significance of the Study

This study, which is descriptive and exploratory in its nature, has some specific features that makes it unique:

1. It represents the first endeavor to investigate how Malaysian employees conceptualize the two organizational constructs of communication satisfaction and organizational commitment.
2. It illustrates the first attempt to investigate the relationship between communication satisfaction and organizational commitment in Malaysia.

Operational Definition

Communication satisfaction

Several definitions of the term "communication satisfaction" have been provided by researchers since it was first introduced by Level (1959). The first definitions of communication satisfaction emphasized the uni-dimensionality of the construct. Thayer (1969) defined the term as the personal satisfaction a person experiences when communication successfully. Redding (1978) in an analysis of several studies, reported that the term communication satisfaction was used "to refer to the over-all degree of satisfaction an employee perceives the total communication environment." More recently Downs and Hazen (1977) attempted to study whether or not communication satisfaction was a multidimensional rather than a uni-dimensional construct. The results of their research indicated that "communication satisfaction" was a multidimensional construct. Based on these findings, the Downs and Hazen study (1977) defined the term as "an individual's satisfaction with various aspects of communication in his organization."

Communication satisfaction for the purpose of this study is defined as individual satisfaction with various aspects of communication in an organization as measured by the Communication Satisfaction Questionnaire (Downs, 1977,1989). Such various aspects of Communication Satisfaction construct are: 1) Organizational Perspective, 2) Personal Feedback, 3) Organizational Integration, 4) Supervisor Communication, 5) Communication Climate, 6) Horizontal Communication, 7) Media Quality, 8) Subordinate Communication, 9) Top Management Communication, and 10) Interdepartmental Communication.

1) Organizational Perspective is the broadest kind of information about the organization as a whole. It includes the notification about changes, the organization's financial standing, and the overall policies and goals of the organization.

2) Personal feedback is concerned with the need of the workers to know how they are being judged and how their performance is being appraised.

3) Organization Integration revolves around the degree to which individuals receive information about their immediate environment. Items include the degree of satisfaction which employees experience with information about departmental plans, the requirements of their job, and some personnel news.

4) Supervisor Communication includes both the upward and downward aspects of communicating with superiors. Three of the principal items are the extent to which supervisors listen and pay attention, and the extent to which superiors are open to ideas, the extent to which supervisors listen and pay attention, and the extent to which superiors and supervisors offer guidance to their employees in solving job-related problems.

5) Communication Climate reflects communication about the organizational and personal levels. It includes items such as the extent to which communication in an organization motivates and stimulates workers to meet organizational goals and the extent to which it makes them identify with the organization. It also includes estimates of whether or not peoples' attitudes towards communicating are healthy for an organization.

6) Horizontal Communication concerns the extent to which horizontal and informal communication is accurate and free flowing. This factor also includes satisfaction with the activeness of the grapevine.

7) Media Quality deals with the extent to which meeting are well organized and written directives are short and clear, and the degree to which the amount of communication is about right.

8) Subordinate Communication focuses on upward and downward communication with subordinates. Only workers in supervisory positions respond to these items which include subordinate responsiveness to downward communication, and the extent to which subordinates initiate upward communication.

9) Top Management Communication evaluates the communication of top management with organization members. This factor includes items about top management attitudes towards openness to new ideas, caring, and willingness to listen.

10) Interdepartmental Communication deals with the communication that is needed between the different departments of the organization in order to facilitate the efficiency of the organization. It includes items about problem solving, teamwork, and communication among managers.

Organizational commitment

Employee commitment is defined as the individual's desire to remain as a member of his or her work-related interest groups. Employee commitment encompasses the domains of organizational commitment, professional commitment, and professional association (union) commitment. In their comprehensive review of commitment in the workplace, Meyer and Allen (1997) offer several directions for future research. First, they suggest that additional research is needed to identify the antecedents that are associated with the multiple domains of employee commitment. To date, previous research on commitment has predominantly focused on an employee's commitment to his or her organization (e.g., Levy & Williams, 1998; Shore & Wayne, 1993).

Meyer and Allen (1997) believed that the relationship between human resource practices and employee commitment should be examined more fully. They asserted, "by understanding how commitment develops, practitioners will be in a better position to anticipate the impact of a particular policy or practice even if it has not yet been the subject of empirical research" (p. 110). The dynamic nature of human resource management in recent decades also affirms the need for more research in this area.

Organizational commitment for the purpose of this study is defined as the relative strength of an individuals' identification with the goals of values of the organization, his or her willingness to help the organization achieve its goals, and his/her strong desire to maintain membership in the organization, specifically it is measured by composite scores on the Organizational Commitment Instrument.

Review of the Literature

The importance of communication in organizational functioning has been stated by many organizational theorists (Ruch, 1989). As a result of its importance, organizational communication is a topic which has received considerable attention in recent years. Even though communication satisfaction is a relatively new construct in the field of organizational communication, many researches have been directed towards determining the relationship between communication satisfaction and other organizational variables. Over 25 different studies, theses, and dissertations, have used the Communication Satisfaction Questionnaire to analyze organizational communication.

A 1977 study by Thiry, which used a sample of 1,160 Kansas nurses, was one of the first to make use of the Communication Satisfaction Questionnaire. The respondents were asked to indicate whether they were satisfied with their present communication practices. The areas of the greatest satisfaction were Subordinate Communication and Supervisor Communication, and the area of the least satisfaction were Personal Feedback and Communication Climate. Pincus (1986) used a modified version of the Communication Satisfaction Questionnaire to study 327 nurses in an urban mid-Atlantic teaching hospital. A new factor of Top Management Communication was added to the other eight communication satisfaction factors. These nurses did not express as much communication satisfaction as did those in the findings of Thiry's (1977) study. The most highly rated factors were Supervisor Communication and Horizontal Communication, and the lowest rated were organizational Perspective and Top Management Communication.

Varona (1988) studied two private sector printing organizations in Guatemala with a sample of 122 employees from one and 45 employees from the other. The employees in both of these companies were generally satisfied with their communication practices. Subordinate Communication, Organizational Integration, and Supervisor Communication were the factors with which the employees were most satisfied. Horizontal Communication, Personal Feedback, and Organizational Perspective were the factors with which employees were least satisfied.

According to Clampitt & Downs (1987), the findings of research regarding communication satisfaction can be summarized as follows:

1. The communication satisfaction construct is multi-dimensional.
2. The communication satisfaction questionnaire has proven to be a useful tool for organizational diagnosis in a wide range of organizations.
3. The studies reviewed indicate that there are definite areas of greatest and least communication satisfaction, although for most part employees are not dissatisfied with organizational communication.
4. Demographic variables provided relatively poor explanations of the level of communication satisfaction.
5. There appear to be some indication that employees in managerial roles are more satisfied with communication that those who are not. However, no clear discernible difference can be detected between employees of profit and nonprofit organizations.
6. Communication satisfaction links significantly to the end-product variables of job satisfaction and productivity.
7. The communication satisfaction construct is more effective than productivity in explaining job satisfaction.
8. There are no clear and strong patterns of relationship between CSQ factors and the end-product variables in these studies. These relationships would probably be contingent on the type of organization and industry in which employees work. The correlation between the eight communication satisfaction factors and job satisfaction was found to be particularly significant while the communication satisfaction/productivity relationship was not clear and strong.

As for organizational commitment, the term commitment has been variously and extensively defined, measured, and researched but it continues to draw criticism for lack of precision and for concept redundancy (Reichers, 1985). The construct of organizational commitment has been researched extensively over the past two decades. These studies have demonstrated the relationship between commitment and several other organizational variables such as absenteeism, leadership style, communication openness and job performance. Recently, the importance of communication in developing commitment has been a major theoretical issue. Some of the pensioner studies that have attempted to investigate the relationship between communication satisfaction and organizational commitment are also revised in this section.

Putti, Aryee, and Phua (1990) examined the relationship between Communication Relationship Satisfaction and organizational commitment in research conducted in a Singapore company with 122 white collar Chinese employees. Result indicated that top management communication, supervisor relationship and global CRS had significant correlations with organizational commitment. Potvin's (1991) also concluded that there was a definite positive relationship between communication satisfaction and employees' organizational commitment. The strongest correlations appeared between commitment composites and communication climate, and the lowest correlations were between commitment factors and organizational perspectives. The Subordinate communication factor also produced fairly low correlations. She also concluded that demographic variables seemed to have no explanatory power with regard to commitment levels.

Downs (1991) studied the relationship between Communication Satisfaction and Organizational Commitment in two Australian organizations. The sample consists of 95 subjects (faculty and staff) of an institute of a higher education and of 100 subjects from a manufacturing firm. The main conclusion of this study is a positive relationship existed between communication satisfaction and organizational commitment. Second, the exact relationship between communication dimensions and levels of commitment varied somewhat across organizations. Third, the relationship with Supervisors, Personal Feedback, and Communication Climate were the strongest communication predictors of organizational commitment.

Methodology

This study was conducted in the following steps. (1) The communication satisfaction and organizational commitment instruments were selected for collecting the data; (2) The instruments were translated into Malay Language (Bahasa Malaysia); (3) The instruments were pre-tested; (4) Data were collected form a public and private organizations; and, 5) Data were analyzed using correlation, t-test, and multiple regression.

Instruments

The instruments used for this study were 1) Downs' 1990 Communication Satisfaction Questionnaire (CSQ) and Meyer and Allen Organizational Commitment Instrument.

Communication Satisfaction Questionnaire: The communication satisfaction questionnaire is an instrument that was developed by Downs and Hazen (1977) a revised version by Downs (1990), The questionnaire was constructed to indicate level of satisfaction of respondents with fifty-two items using a one to seven point scale which ranged between "very satisfaction" and "very unsatisfied". Two additional questions referred to changed experienced in job satisfaction and productivity. Two open-ended questions asked for suggestions to improve communication satisfaction and productivity.

Commitment: To determine factors related to organizational commitment, the concept of organizational commitment must be clearly defined. One commonly used definition of organizational commitment was developed by Porter et al. (1974). In their definition, three factors of organizational commitment were identified: a strong belief in and acceptance of the organization's goals and values, a willingness to exert considerable effort on behalf of the organization, and a strong desire to remain in the organization. A fifteen-item organizational commitment questionnaire (OCQ) was developed to measure organizational commitment based on this definition.

Allen and Meyer (1990) separated organizational commitment into three components: affective, continuance and normative. The affective component refers to the employee's emotional attachment to, identification with, and involvement in the organization. The continuance component refers to commitment based on the costs that the employee associates with leaving the organization. The normative component refers to the employee's feelings of obligation to remain with the organization. Allen and Meyer (1990) developed a twenty-four-item scale to measure the three components of organizational commitment.

Hypotheses

Based on the prior research findings, for the purpose of present study several hypotheses are generated. The first hypotheses concerned with the direction and strength of the relationship between communication satisfaction and organizational commitment.

H1: There is a significant and positive relationship between organizational communication satisfaction and organizational commitment.
H2: There is different levels of organizational communications satisfaction among private and public sector employees.
H3: There is different levels of organizational commitment among private and public sector employees.

Procedure

Collectively, a total of 850 questionnaires were sent to public organization and 830 questionnaires were sent to private organization. A total of 317 questionnaires from public sector and 325 from private sector were returned, yielding a 40 percent return rate.

Respondents

The majority of the respondents were male (57.60%, n=317 in public sector; 55.70%,n=307 in private sector). Most of the respondents were married (84.60% in private sector; 81.43% in public sector). A total of 88.40% of the respondents in private sector and 78.53 % of the respondents in the public sector were Malays. Respondents reported their work experiences was slightly over than 13 years (58.2 % in public sector; 54.4% in private sector). In term of academic qualification, approximately 59.75% in private sector and 49.84% in private sector had earned Malaysia Certification of Examination (Sijil Pelajaran Malaysia) and below.

Results and Discussion

Data were analyzed by a Pearson Correlation. Hypothesis 1 addressed the relationship between organizational communication satisfaction and organizational commitment. Results of a Pearson Correlation revealed a significant and positive relationship between the two variables in the private($r=.54$, $p< 0.05$) and public organization ($r=.77$; $p < 0.01$). The higher the quality of communication satisfaction, the greater organizational commitment among the employees at the public and private sectors in Malaysia. This suggests that people who are satisfied with their organizational communication will also be committed to the organization.

There is a significant and positive relationship between every communication satisfaction dimensions and organizational commitment. For private sector, the dimension that correlates higher with organizational commitment is Media Quality. This is followed by Supervisor Communication, Horizontal/Informal Communication and Communication Climate. For public sector, Media Quality also becomes the highest dimension that correlate with organizational commitment. This is followed by Organizational Intergration, Subordinates Communication and Horizontal/Informal Communication.

TABLE1: CORRELATION BETWEEN COMMUNICATION SATISFACTION DIMENSIONS AND ORGANIZATIONAL COMMITMENT

Dimensions	Private Sector r*	Public Sector r*
Organizational Integration	.39	.68
Subordinates Communication	.38	.61
Horizontal/Informal Comm.	.47	.61
Media Quality	.55	.69
Satisfaction with Superiors	.39	.62
Personal Feedback	.38	.60
Organizational Perspective	.30	.57
Communication Climate	.46	.67
Supervisory Communication	.51	.65

Note: * $p < 0.01$

Hypothesis 2 tested the differences of communication satisfaction among public and private organizations. Results of t-test revealed a significant difference between public and private organization in terms of communication satisfaction (Table 2).

Hypothesis 3 examined the differences of organizational commitment among public and private sector employees. Results of t-test revealed a significant difference between public and private employees in term of their organizational commitment (Table 2)

TABLE 2: T-TEST FOR DIFFERENCES IN COMMUNICATION SATISFACTION, JOB SATISFACTION AND ORGANIZATIONAL COMMITMENT IN PUBLIC AND PRIVATE SECTOR

Variables	Sector	n	Mean	Std. Dev	t-value	Sig.
Communication Satisfaction	Public	306	130.16	26.94	8.23	.00
	Private	319	112.86	21.88		
Organizational Commitment	Public	306	70.97	14.07	3.81	.00
	Private	319	66.21	16.99		

Discussion and Conclusion

Hetch (1978) noted that the study of communication satisfaction is of importance to the communication field. Hetch also suggested that communication satisfaction is an outcome of communication behaviors and thus, serve as the basic for a holistic theoretical approaches to the field. In organizational settings, communication has been consistently found to be crucial to job satisfaction, task performance, productivity, and commitment (Clompitt & Downs, 1993; Pincus, 1986). Given that communication satisfaction is vital to organizational life, the present study makes a valuable contribution to the extent relationships.

As predicted, communication satisfaction positively affected subordinates perceived organizational commitment. The higher the quality of communication satisfaction, the more subordinates reported higher level of organizational commitment. These finding are consistent with the theoretical perspective and empirical discoveries of communication satisfaction studies.

Findings reported in this study have important practical and theoretical implications to increase overall level of organizational commitment among their subordinates, superior should offer opportunities to develop and maintain higher quality of organizational communication.

Meyer and Allen (1990) suggested that organizational commitment is greatly influenced by employee's perceptions of achievement, recognition, attraction of the work itself, responsibility and advancement. Further, more organizational commitment is closely tied to communication satisfaction. Thus in order to enhance their subordinates perception of communication satisfaction, superior should work on ways in which they can improve the quality of communication with subordinates.

Subordinates too, can learn about and actively enjoy in communication behaviors that positively affect the quality of organizational communication with their superior. By improving the quality of organizational with superior, subordinates' are likely to experience more informal and formal rewards and interact with their superior within a more open communication environment for example greater feedback opportunities in decision making, information sharing, and the like, and, thus, experience more satisfying communication at the workplace.

The study also found that there is a difference in terms of communication satisfaction and organizational commitment among public and private sector employees in Malaysia. The communication satisfaction and organizational commitment is higher for public sector employees compared to private sector employees. This is due to public organizations allegedly differ from private organizations in that public and private employees, on the whole, have different attitudes about their work and somewhat different incentive structures (Bozeman, 1989).

As with all research, the present study has limitations. For instance, the respondents consist of those who work in public and private sector in Malaysia. Therefore, findings from this study may not be generalized to draw conclusions on all multinational organizations operating in Malaysia. Care should be excercised when generalizing the results from the present study.

Any social relationship including the superior-subordinate relationship is not marked by smooth continuity. (Duck & Pittman, 1994). Instead, such relationships are exposed to everyday "ups and downs" and undergo stressful situation. Accordingly, subordinates communication will likely fluctuate over time. Thus, as Pincus (1986) emphasized, future study should employ longitudinal research designs to delineate routine and non-routine communication behaviors in differing organizational commitment. Also, additional research should identify other variables within other communication organizational context that affect and are affected by communication satisfaction in the workplace.

Conclusions

The above findings, however, must be interpreted with caution because the current study has limitations. The study is restricted to service organization only. Therefore, generalizing the results reported in this paper to other sectors (such as manufacturing company) should be done cautiously. Furthermore, this study is constrained to Malaysia. It is possible that public sectors in other countries differ from their Malaysia counterparts. This may be so because of legal and regulatory constraints and economic policies or structures that might differ among countries. Thus, it might not be possible to generalize the findings in this study to others. Future research may be designed to compare the findings in this study with findings that relate to industries in other countries.

References

Contact the author for a list of references.

The Determinants of Poverty in Mexico: 2002

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Abstract

This study examines the determinants or correlates of poverty in México. The data used in the study come from the 2002 National Survey of Income and Expenditures of Households.

Using the official extreme poverty line, a logistic regression model was estimated based on this data, with the probability of a household being extremely poor as the dependent variable and a set of economic and demographic variables as the explanatory variables. It was found that the variables that are positively correlated with the probability of being poor are: having a female household head, size of the household, living in a rural area, household head working in agriculture, working without remuneration and having a self-employed household head. Variables that are negatively correlated with the probability of being poor are: education level, age of the household head and whether the occupation of the household head is being a small entrepreneur or not.

1. Introduction

Poverty in Mexico is widespread and pervasive. According to official Mexican Government estimates [Cortés, Fernando; Hernández, Daniel; Hernández, Enrique; Székely, Miguel; Vera, Hadid. 2002], 52.7 million people were living in poverty in 2002, which represents 51.7 percent of the Mexican population. Extreme poverty affected 20.7 million people, equivalent to 20.7 percent of the total population.

The high poverty rates prevalent in the country are a reflection of both low incomes and an unequal income distribution. Mexico has one of the more unequal income distributions in the world. According to the World Bank [1999], only eleven countries in the world have a worse income distribution than Mexico. This feature of the Mexican economy is not new; it has been one of its distinct characteristics for a long time. According to Székely [1998] income distribution in Mexico improved between the years of 1950 and 1984, but then worsened after that year. The Gini coefficient decreased from 0.52 in 1950 to 0.44 in 1984 but then increased to 0.49 in 1992 and increased even further to around 0.52 during the rest of the nineties.

During the 1980's and 1990's, the period in which income distribution has become more unequal, the Mexican economy experienced a deep transformation which involved a major shift in the development model that the country had been following until the 1970´s. Important manifestations of this change were the macroeconomic stabilization programs that were implemented, the process of trade liberalization, the privatization of state-owned enterprises and banks, deregulation and the reduction or elimination of barriers to foreign investment in important sectors of the economy since 1988.

After these reforms, the Mexican economy started to grow consistently, although slowly, from 1987 until 1994. However, after a series of political events, including the appearance of a guerilla movement in the south of the country and the assassination of the Institutional Revolutionary Party presidential candidate, the Mexican economy entered one of the most profound crises in recent history. Gross Domestic Product fell 6.2 percent in 1995 and the peso lost half its value against the dollar. The real minimum wage fell by 13 percent, while real private consumption decreased 9.6 percent. Although the economy eventually recovered during 1996, the gains were not enough to compensate for the losses that occurred during 1994. Thus, per capita real GDP was still 4.8 percent lower in 1996 as compared to 1994, average real wages were 22 percent lower than in 1994 and real private consumption was 7.5 percent below the 1994 figure. During the 1994-1996 period there was a slight improvement in income distribution in the country. The Gini Index decreased from 0.5338 in 1994 to 0.5191 in 1996. The income share of the lowest three deciles increased slightly and the share of the highest decile decreased. However, a closer look at the income distribution reveals that the persons situated in the lowest three percentiles of the distribution, the poorest of the poor, reduced their share during the period.

According to the estimates obtained by Garza-Rodríguez [2000], both moderate and extreme poverty increased in Mexico during the 1994-1996 period, and both the depth as well as the severity of poverty also increased in the same period. Although the author did not decompose the poverty changes as due to decrease in income and the worsening of income distribution, it is possible that both factors played a role in the increase in poverty levels that occurred during the period. Thus, although the Gini coefficient declined during the period, indicating a reduction in income inequality, the Lorenz curves for the two years intersect in the lower percentiles of income, which indicates that the income share of the poorest of the poor decreased during the period.

The poverty profiles constructed by the author for both years indicate that although poverty is predominantly rural in Mexico (60 percent of the rural population was poor in 1996), urban poverty more than doubled during the period, from 9 percent of urban population in 1994 to 21 percent in 1996. This indicates that although poverty alleviation programs should concentrate in the rural sector, the urban sector should not be neglected when designing and implementing policies to mitigate poverty.

Another variable that the poverty profiles suggested as an important determinant of poverty was the level of education of the household head. In both years considered in the study, poverty incidence was higher the lower the level of instruction of the household head. For example, 58 percent of the number of people living in households headed by persons with no instruction was poor in 1996, while only 2.7 percent of the number of people living in households headed by persons with at least a year of college was poor in the same year.

Suggesting a strong correlation between poverty and occupation of the household head, poverty incidence is higher for households whose head works in a rural occupation or in a domestic occupation and it is lower for households whose head works in a professional occupation or in a middle level occupation.

The poverty profiles also showed that poverty rates are higher for households with the following characteristics: they live in rural areas, have more than five family members, their head has a low level of education and works in the primary sector or in a domestic occupation.

To test the hypothesis about the determinants or correlates of poverty we use a logistic regression with the dependent variable being the dichotomous variable of whether the household is extremely poor (1) or is not extremely poor (0). The explanatory variables considered in the analysis were: gender, age, education, the occupation of the household head, and size and location (rural or urban) of the household.

The paper is organized as follows: Section 2 reviews the literature and main empirical findings about the determinants of poverty in several countries and in Mexico; Section 3 describes the ENIGH 2002 Survey as well as the selection of variables from the Survey that will be used in this study. Section 4 presents the results of the multivariate analysis to explore the determinants of poverty in Mexico based on the 2002 ENIGH dataset. Finally, Section 5 proposes some conclusions based on the analysis developed in this study.

1.1 Studies about the Determinants of Poverty

Although the construction of poverty profiles is useful because it allows us to know whether poverty is increasing or decreasing as well as the changes in the composition of the population in poverty, poverty profiles do not throw much light about the causes of poverty. They only provide a description of poverty according to several economic, demographic or social characteristics, but do not go in depth as to look for the underlying causes of differences in poverty rates across population groups and/or across time.

However, while the literature on poverty measurement is by now relatively developed and abundant, there are very few studies dealing with finding the determinants or causes of poverty. In general, these studies have used different methodologies, including ordinary least square regression where the dependent variable is continuous, logistic regression where the dependent variable is binary, and quantile regressions where the dependent variable is income.

In one of the first studies about the determinants of poverty, Kyereme and Thorbecke [1991] estimated a cross-section regression model for Ghana, using the 1974-1975 Ghana Household Budget Survey. In their model, the dependent variable was the total calorie gap for each household in the Survey and the explanatory variables were a set of economic, demographic and geographic location variables. They found that income and education of the household are inversely related to household calorie gap. Rodríguez and Smith [1994] used a logistic regression model to estimate the effects of different economic and demographic variables on the probability of a household being in poverty in Costa Rica. The data they used was from a national household-income survey carried out in

1986. Among other results, the authors found that the probability of being in poverty is higher the lower the level of education and the higher the child dependency ratio, as well as for families living in rural areas.

Coulombe and McKay [1996] used multivariate analysis to analyze the determinants of poverty in Mauritania based on household survey data for 1990. They estimated a multinomial logit model for the probability of being in poverty depending on household-specific economic and demographic explanatory variables. The authors found that low education, living in a rural area and a high burden of dependence significantly increase the probability of a household being poor.

1.2 Studies about the Determinants of Poverty in Mexico

Studies about the determinants of poverty in Mexico are few, and they use different methodological approaches.

Cortés [1997], using the ENIGH 1992, estimates a logistic regression of the probability of being poor as a function of several economic, demographic and location variables. He finds that the probability of being poor decreases with the number of years of education and increases with the burden of dependency and if the household is located in a rural area.

Székely [1998], using a different approach and based on the 1984, 1989 and 1992 Surveys reaches the conclusion that lack of education is the single most important factor in explaining poverty in the country. Other variables that he found as directly related to poverty are: household size, living in a rural area, and occupational disparities.

2. Description of the Data

2.1. Description of the Survey

This paper uses the information contained in the micro data from the National Survey of Incomes and Expenditures of Households (ENIGH) for 2002, carried out in that year by the Instituto Nacional de Estadistica, Geografia e Informatica (INEGI), Mexico´s national institute of statistics. The ENIGH surveys are carried out by INEGI every two years since 1992 and they are comparable since they follow the same methodology.

The surveys' sampling unit is the house and the unit of analysis is the household. The household and its members can be classified according to various socio-economic and demographic characteristics such as income and occupational characteristics, the physical characteristics of the residence and the services available to the residents of the household.

The characteristics included in the Survey are the following (and refer to the household residents): kinship relationship with the household head, gender, age, instruction level attained, school attendance, literacy status, and type of school attended.

The economic transactions considered in the surveys are current transactions and financial or capital transactions. Current transactions include current income and current expenditures. Current income includes both monetary and non-monetary income (in-kind payments) received by household members during the reference period. The income concept registered in the surveys is net income, after deducting taxes, social security payments, union payments or other deductions. Current monetary income includes the following sources: wages, entrepeneurial income, rents, incomes from cooperatives, transfer payments and other current income. Non-monetary income comprises: auto-consumption (household production consumed in the household), in-kind payments, gifts, and the imputed rent from owner-occupied housing.

The Survey is statistically representative at the national level and at the urban and rural level, which implies that it is not possible to obtain inferences at the state level.

The Surveys include information about expansion factors for each selected house, and they are equal to the inverse of the probability of selection. In this sense, the expansion factor for each selected house indicates the number of houses that each house represents in the total population of dwelling units.

2.2. Poverty Line used in this Study

The poverty line used in this study is the official "food poverty line", which could be interpreted as an extreme poverty line. This poverty line (measured at prices of the year 2000) is equal to 15.4 pesos per person per day for rural areas and 20.9 pesos per person per day for urban areas. This is the income necessary to purchase a minimum food bundle that satisfies the minimal nutritional requirements. Therefore, persons with income below this level are considered extremely poor since they do not have the income to buy enough food to satisfy their nutritional requirements.

3. Econometric Model

3.1. Introduction

Garza-Rodríguez [2000] analyzed the evolution of poverty levels and poverty profiles during the period 1994-1996. He looked at the issue of what happened to poverty during the period as well as what happened to the composition of the poor according to several demographic and socioeconomic characteristics. This knowledge can be useful since it allows us to know whether poverty is increasing or decreasing as well as the changes in the composition of the poor. However, it does not provide us with much insight about the causes of poverty. For example, is poverty higher in rural areas only because education attainment is low and family size is high in rural areas or is poverty high in rural areas even if we control for those variables?

While the literature on the measurement of poverty is relatively abundant, studies about the determinants or causes of poverty are scarce. However, it is precisely in this area where research can be most useful, since the main causes of poverty need to be understood in order to be able to design the most efficient policies to reduce it.

There are several approaches that can be taken in the analysis of the causes of poverty. If we follow the income approach, poverty can be thought as being caused by lack of income, which in turn can be caused by reduced command of economic resources available to the household. Thus, in general terms, poverty can be thought as being due to the limited amount of assets owned by the poor and to the low productivity of these assets.

Many variables can be considered as the determinants of income, and thus, of poverty. We can divide these variables into two general areas: the characteristics associated with the income generating potential of individuals and the characteristics associated with the geographic context in which the individual lives. The first kind of characteristics would include, for example, the assets owned by the individual, both physical and human, while the second type of characteristics would include, for example, the place in which the individual lives (urban or rural). However, there are severe problems in determining the direction of causality. Does poverty cause the characteristic or is it the presence of a given characteristic which causes poverty?. An example of this problem is whether poverty causes large households or a large household causes poverty. It is necessary to determine the direction of causality, but this is a difficult task that has not been solved yet due among other things to the unavailability of better data, especially panel data in developing countries. What we will try to do in this study is to get an approximation about the determinants of poverty, even if they could more properly be called the correlates of poverty.

We also need to separate the effects of correlates. For example, if we find that poverty is highly correlated with rural location, and rural location is highly correlated with low education, then we need to know how much poverty is due to rural location and how much is due to low education. We approach this problem through the use of multivariate analysis, using a logistic regression. In order to explore the correlates of poverty with the variables thought to be important in explaining poverty a logistic regression model was estimated, with the dependent variable being the dichotomous variable of whether the household is extremely poor (1) or not extremely poor (0). The explanatory variables considered in the analysis were: gender, age, education and position in occupation of the household head, and size and location (rural or urban) of the household.

In this model, the response variable is binary, taking only two values, 1 if the household is extremely poor, 0 if not.

$$\text{Prob}(Y = 1) = \frac{e^{\beta' x}}{1 + e^{\beta' x}}$$

The probability of being extremely poor depends on a set of variables $\mathbf{x}$ so that:

$$\text{Prob}(Y = 1) = F(\beta' \mathbf{x}), \qquad \textbf{(1)}$$

$$\text{Prob}(Y = 0) = 1 - F(\beta' \mathbf{x}) \qquad \textbf{(2)}$$

Using the logistic distribution we have:

(3)

(4)

E[y | x] ? 0[1 - F(ß ' x)] ? 1[F(ß ' x)]
? F(ß ' x)

Where ? represents the logistic cumulative distribution function.
Then the probability model is the regression:

(5)
(6)

3.2. Empirical Results

The estimated regression is shown in Table 1. Except for the variables of being an entrepreneur or a member of a cooperative, all of the coefficients in the regression are significantly different from zero at the 95 percent confidence level. The variables that are positively correlated with the probability of being poor are: being a female household head, size of the household, living in a rural area, working in agriculture, working without remuneration and being self-employed. The variables that are negatively correlated with the probability of being poor are: having at least one year of primary education, having completed primary education, having at least a year of secondary education, having at least a year of preparatory school (senior high school) and having at least a year of college. Besides education, other variables negatively correlated with poverty are age of the household head and being a small entrepreneur.

Table 1. LOGISTIC ESTIMATES OF POVERTY DETERMINANTS

Logit estimates Number of obs = 13727
LR chi2(15) = 3461.91
Prob > chi2 = 0.0000
Log likelihood = -4919.9798 Pseudo R2 = 0.2603

POBALIM	Coef.	Std. Err.	z	P>|z|	[95% Conf. Interval]
FEMALE	.3049149	.077831	3.92	0.000	.152369 .4574607
HHSIZE	.3086312	.0123905	24.91	0.000	.2843462 .3329161
RURAL	.7718235	.0583982	13.22	0.000	.6573652 .8862819
AGE	-.0364757	.0022364	-16.31	0.000	-.040859 -.0320924
AGWORKER	1.207869	.0815507	14.81	0.000	1.048033 1.367706
WHOPMTWORKER	1.383289	.5028421	2.75	0.006	.3977367 2.368842
COOPMEMBER	.1539129	.60445	0.25	0.799	-1.030787 1.338613
SELFEMPLOYED	.9119334	.062237	14.65	0.000	.7899512 1.033916
SMALLENTRPNR	-.4513081	.1626262	-2.78	0.006	-.7700496 -.1325665
ENTREPENEUR	-.0906324	.4155116	-0.22	0.827	-.9050201 .7237553
INCOMPELEM	.7095517	.07329	-9.68	0.000	-.8531974 -.565906
COMPLEM	-1.159857	.0840046	-13.81	0.000	-1.324503 -.9952114
ATLSOMEHS	-1.579	.0937311	-16.85	0.000	-1.762709 -1.39529
ATLSOMEPREP	-2.317717	.1498255	-15.47	0.000	-2.61137 -2.024065
ATLSOMEUNIV	-3.323885	.2275425	-14.61	0.000	-3.76986 -2.87791
CONSTANT	-1.143369	.1509096	-7.58	0.000	-1.439147 -.8475919

The

variables in Table 4 are defined as follows:

Dependent Variable:

POBALIM	Binary variable indicating whether a household is below the extreme poverty line or not (1 if extremely poor, zero if not).

Independent Variables:

FEMALE	Binary variable indicating whether the household head is female or male (1 if female, zero if male).
RURAL	Binary variable indicating whether a household is located in a rural area (less than 15,000) or in an urban area (1 if located in rural area, zero if not).
HHSIZE	Size of the household.
AGE	Age of the household head.
AGWORKER	Binary variable indicating whether the household head works in agriculture or not.
WHOPMTWORKER	Binary variable indicating whether the household head receives payment or not.
COOPMEMBER	Binary variable indicating whether the household head works as a member of a cooperative or not.
SELFEMPLOYED	Binary variable indicating whether the household head is self-employed or works in the household without receiving remuneration or not.
SMALLENTRPNR	Binary variable indicating whether the household head is a small entrepreneur (employing from 1 to 5 workers) or not.
ENTREPENEUR	Binary variable indicating whether the household head is a large entrepreneur (employing more than 5 workers) or not.
INCELEM	Binary variable indicating whether the household head has incomplete elementary education or not.
COMPELEM	Binary variable indicating whether the household head has completed elementary education or not.
ATLSOMEHS	Binary variable indicating whether the household head has at least a year of high school or not.
ATLSOMEPREP	Binary variable indicating whether the household head has at least a year of senior high school or not.
ATLSOMEUNIV	Binary variable indicating whether the household head has at least a year of college or not.

3.3 Marginal Effects and Odds Ratios

Since the logistic model is not linear, the marginal effects of each independent variable on the dependent variable are not constant but are dependent on the values of the independent variables (Greene, 1993). For the logistic distribution we have:

$$\frac{d\Lambda[\boldsymbol{\beta}'\mathbf{x}]}{d(\boldsymbol{\beta}'\mathbf{x})} = \frac{e^{\beta'x}}{(1+e^{\beta'x})^2} = \Lambda(\boldsymbol{\beta}'\mathbf{x})[1-\Lambda(\boldsymbol{\beta}'\mathbf{x})]\boldsymbol{\beta} \qquad \textbf{(7)}$$

Thus, as opposed to the linear regression case, it is not possible to interpret the estimated parameters as the effect of the independent variables upon poverty. However, it is possible to compute the marginal effects evaluating expression (7) at some interesting values of the independent variables, such as the means of the continuous independent variables and for some given values of the binary variables. This is the procedure we will use in the next sub-sections to draw graphs showing the effect of the independent variables on poverty.

Another way to analyze the effects of the independent variables upon the probability of being poor is by looking at the change of the odds ratio as the independent variables change. The odds ratio is defined as the ratio of the probability of being poor divided by the probability of not being poor. Table 2 shows the odd ratios for each independent variable as well as its corresponding standard error and confidence intervals, with the variables' labels being the same as in Table 4.1

TABLE 2. ODDS RATIOS ESTIMATES OF POVERTY DETERMINANTS

Logit estimates	Number of obs	=	13727
	LR chi2(15)	=	3461.91
	Prob > chi2	=	0.0000
Log likelihood = -4919.9798	Pseudo R2	=	0.2603

POBALIM	**Odds Ratio**	**Std. Err.**	**z**	**P>|z|**	**[95% Conf. Interval]**
FEMALE	1.35651	.1055784	3.92	0.000	1.16459 1.580057
HHSIZE	1.36156	.0168704	24.91	0.000	1.328893 1.39503
RURAL	2.163708	.1263566	13.22	0.000	1.929701 2.426092
AGE	.9641815	.0021563	-16.31	0.000	.9599645 .9684171
AGWORKER	3.346347	.2728971	14.81	0.000	2.852035 3.926333
WHOPMTWORKER	3.987997	2.005333	2.75	0.006	1.488452 10.68501
COOPMEMBER	1.166389	.7050241	0.25	0.799	.356726 3.813751
SELFEMPLOYED	2.48913	.1549159	14.65	0.000	2.203289 2.812055
SMALLENTRPNR	.6367946	.1035595	-2.78	0.006	.4629901 .8758447
ENTREPENEUR	.9133534	.3795089	-0.22	0.827	.4045338 2.062163
INCELEM	.4918647	.0360487	-9.68	0.000	.4260505 .5678455
COMPLEM	.3135309	.026338	-13.81	0.000	.265935 .3696453
ATLSOMEHS	.2061812	.0193256	-16.85	0.000	.1715794 .2477611
ATLSOMEPREP	.0984982	.0147575	-15.47	0.000	.0734339 .1321173
ATLSOMEUNIV	.0360126	.0081944	-14.61	0.000	.0230553 .0562522

As can be seen in the Table, the variables FEMALE, HHSIZE, RURAL, AGWORKER, WHOPMTWORKER and SELFEMPLOYED have odd ratios greater than one, which means that these variables are positively correlated with the probability of being poor.

On the contrary, the variables AGE, SMALLENTRPNR, INCELEM, COMPELEM, ATLSOMEHS, ATLSOMEPREP and ATLSOMEUNIV all have odd ratios lower than one, which means that these variables are negatively correlated with the probability of being poor.

The confidence interval for the odd ratios of COOPMEMBER and ENTREPENEUR includes the number one, which means that these variables have no statistically significant effect on the probability of poverty.

3.4. Poverty and Gender

Several studies have discussed the phenomenon of the feminization of poverty, which is said to exist if poverty is more prevalent among female-headed households than among male-headed households. This situation might be due to the presence of discrimination against women in the labor market, or it might be due to the fact that women tend to have lower education than men and therefore they are paid lower salaries. Using a different methodology than the one used in this chapter, Székely [1998] found no evidence that female-headed households are more likely to be poor than male-headed households. Using a logistic regression and the 1992 National Survey of Income and Expenditures, Cortés [1997] finds that the probability of being poor decreases by six percent if the household is headed by a woman.

Looking at the results of the logistic regression estimated above, it can be seen that the probability of being poor increases if the household head is female, although the marginal effect of this variable is relatively small.

Figure 1 shows the probability of being poor for male and for female-headed households. This graph is drawn based on the following assumptions about the values of the independent variables: the household head is 43.9 years old (the sample mean for this variable), the household is located in a urban area (63.5 percent of the households in the sample are located in a urban area), the household's head did not complete elementary education (the most representative education level of household heads in the sample) and the household head occupation is "not agricultural worker" (55.4 percent of the sample) .

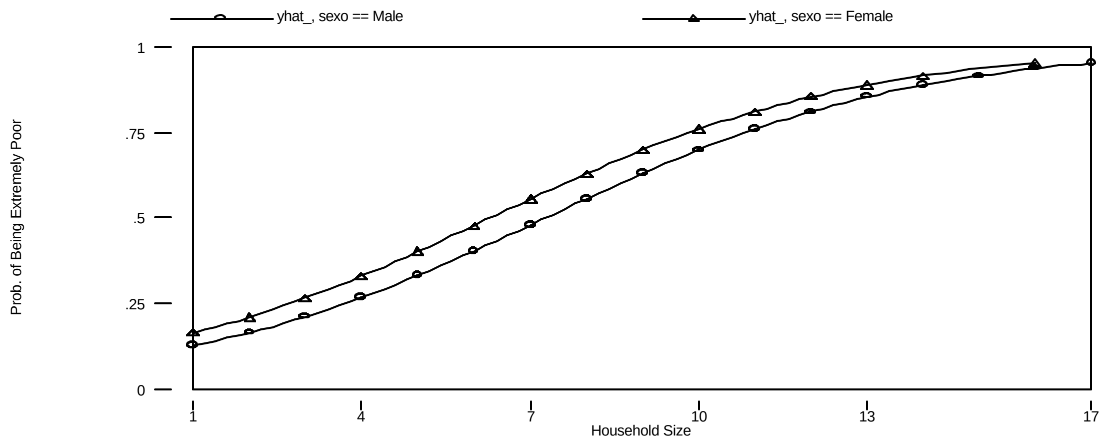

FIGURE 1. PROBABILITY OF BEING POOR AND GENDER OF THE HEAD

3.5. Poverty and Age

It is argued that poverty increases at old age as the productivity of the individual decreases and the individual has few savings to compensate for this loss of productivity and income. This is more likely to be the case in developing countries, where savings are low because of low income. However, the relationship between age and poverty might not be linear, as we would expect that incomes would be low at relatively young age, increase at middle age and then decrease again. Therefore, according to life-cycle theories we would expect to find that poverty is relatively high at young ages, decreases during middle age and then increases again at old age.

For the case of Mexico and based on the 1984, 1989 and 1992 Surveys, Székely [1998] finds that age of the head is not relevant in explaining poverty. However, using the 2002 survey and the methodology developed above we found that age of the head is statistically significant in explaining poverty, although the effect is not very strong, since as can be seen in Table 2 above, an increase of one year in the age of the head decreases the odds of being poor by only 3.6 percent.

As Figure 2 shows, the probability of being poor decreases with age. This graph is drawn based on the following assumptions about the values of the independent variables: household size is 4.1 members (the mean for this variable in the sample), the household head is male (80 percent of the households in the sample are headed by men) the household is located in a urban area, the household's head did not complete elementary education, and the household head occupation is "not agricultural worker"

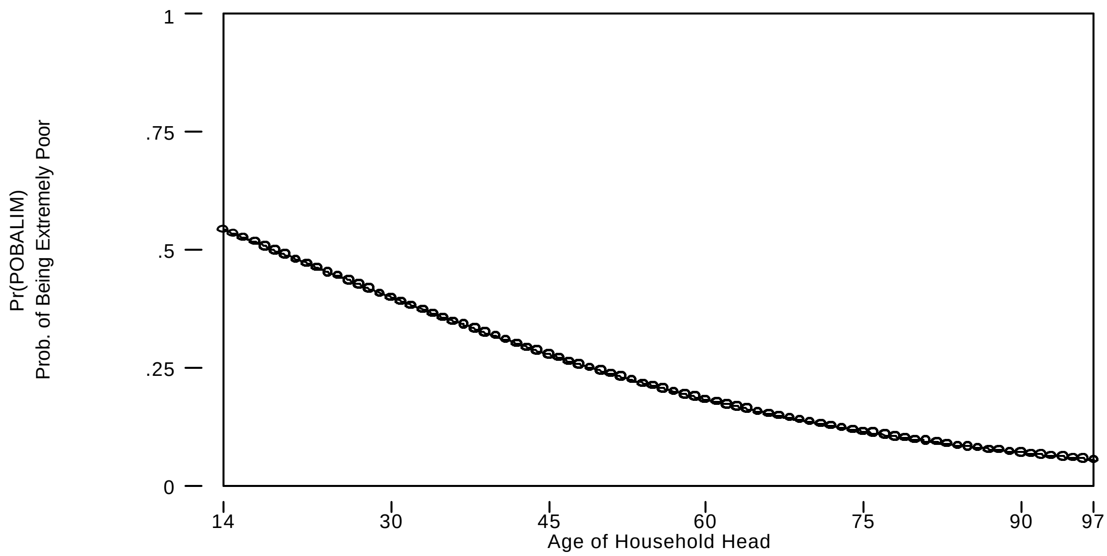

FIGURE 2 PROBABILITY OF BEING POOR AND AGE

3.6. Poverty and Household Size

Large households tend to be associated with poverty [World Bank (1991a,b), Lanjouw and Ravallion (1994)]. The absence of well developed social security systems and low savings in developing countries will tend to increase fertility rates, especially among the poor, in order for the parents to have some economic support from the children when parents reach old age. It might be rational for them to increase the number of children in order to increase the probability that they will get support when they get old. High infant mortality rates among the poor will tend to provoke excess replacement births or births to insure against high infant and child mortality, which will increase household size [Schultz, 1981].

For Mexico's case Székely [1998], using the 1984, 1989 and 1992 Surveys, found that household size is relevant in explaining poverty, while Cortés [1997], based on the 1992 Survey, found a direct relationship between poverty and the burden of dependency. Using the 1996 data, we obtained similar results since, as can be seen in Table 4.2 above, an increase of one in the size of the household increases the odds of being poor by 41 percent**.**

Fig. 3 shows the probability of being poor as the size of the household increases from its minimum to its maximum, assuming that the independent variables take the following values: the household head is 43.9 years old, the household head is male the household is located in a urban area, the household's head did not complete elementary education , and the household head occupation is "not agricultural worker".

It can be seen in Fig. 3 that the effect of a change in household size upon the probability of being extremely poor is pronounced, and that this effect increases relatively rapidly up to a household size of around 10 members and then increases less rapidly up to the maximum household size of 17. Since 95 percent of households have between 1 and 9 members, the first part of the curve is the most relevant, which implies that household size has a strong correlation with poverty in Mexico,

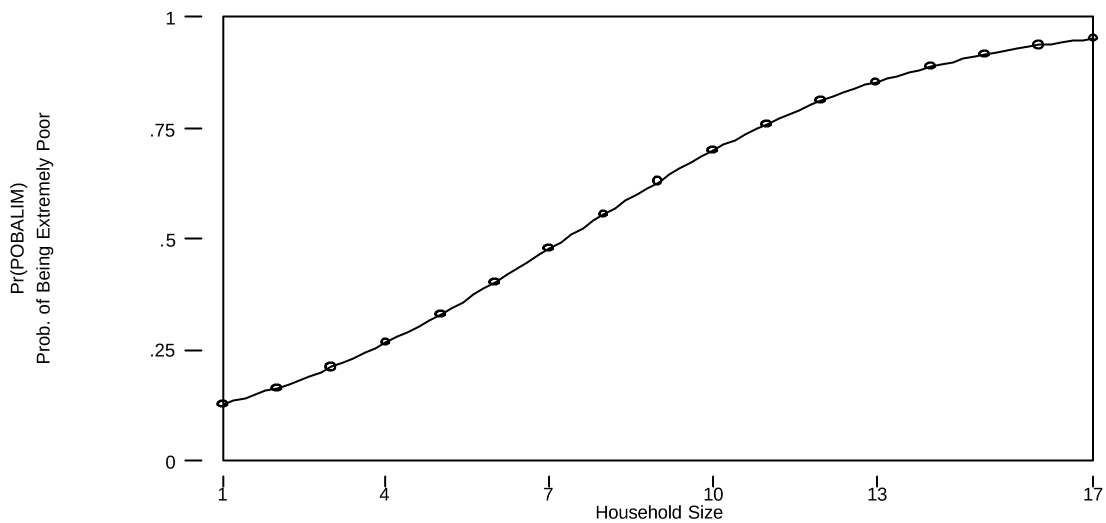

FIGURE 3 PROBABILITY OF BEING POOR AND SIZE OF THE HOUSEHOLD.

3.7. Poverty and Rural-Urban Location

One of the most salient facts about poverty in developing countries is that it is higher in rural areas than in urban areas. The World Bank [1990] reports that the rural poverty rate was higher than the urban poverty rates for many developing countries during the 1980's. For example, in Kenya the rural poverty rate was six times the urban poverty rate, while in Mexico it was 30 percent higher during the same period. Although there may be problems associated to determining the direction of causality, several variables might explain why poverty is higher in rural areas than in urban areas. First, rural areas are heavily dependent on agricultural production, which in developing countries is characterized by low labor productivity and therefore low incomes. Second, historically government policy has been biased against rural areas, including price policy, educational policy, housing, and public services in general. Third, natural disasters such as drought or flooding tend to affect rural areas more heavily than they affect urban areas, and although at first we might think that these phenomena would only affect transient poverty they affect the stock of capital of the communities which in turn have a permanent adverse effect on poverty rates.

By constructing a poverty profile using the 1984 Survey, Levy [1994] concludes that poverty in Mexico is a predominantly rural phenomenon characterized by higher poverty rates in rural areas than urban areas. Cortés [1997] finds that the probability of being poor increases if the household is located in a rural area. Székely [1998] also concludes that rural-urban location is statistically significant as a cause of poverty in Mexico.

Our own estimates using the logistic regression for the 2002 survey indicate that rural location has a statistically significant positive effect on the probability of being poor. As shown in Table 2, the odds of being poor for a household located in a rural area are more than twice the odds of an urban household.

Fig. 4.4 shows the effect of the size of the household and rural/urban location of the household upon the probability of being poor assuming that the independent variables take the following values: the household head is 43.9 years old, the household is located in a urban area the household's head did not complete elementary education and the household head occupation is "not agricultural worker".

It can be seen from the graph that the probability of being poor is significantly higher for a household located in a rural area than for one located in an urban area.

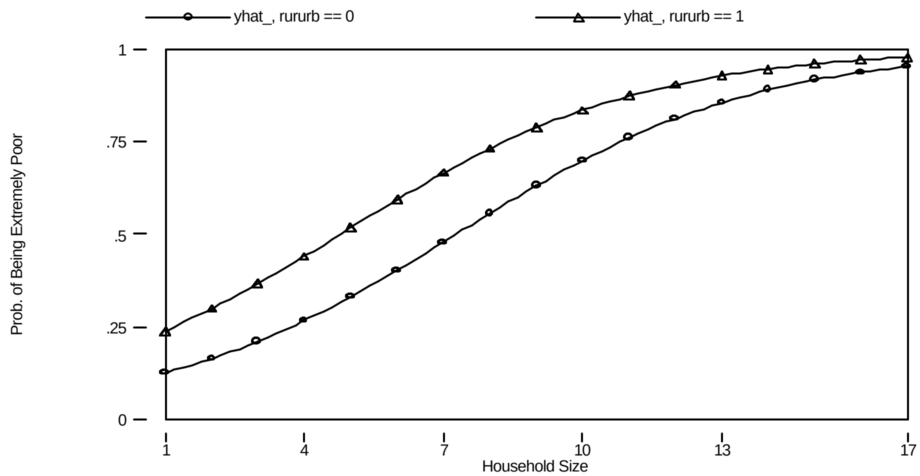

Figure 4. PROBABILITY OF BEING POOR AND RURAL/URBAN LOCATION.

3.8. Poverty and Position in Occupation

Position in occupation of the household head has a high correlation with poverty because positions which require low amounts of capital, either human or physical, will be associated with low earnings and therefore with higher poverty rates. In our model we found that working in agriculture, working without remuneration and being self-employed worker increases the probability of being poor, while being a small entrepreneur decreases such probability. Fig. 5 shows the effect of the position in occupation variable on the probability of poverty, based on the following assumptions about the values of the independent variables: household head is 43.9 years old, the household head is male, the household is located in a urban area, and the household's head did not complete elementary education. It can be seen from the graph that the probability of being poor is higher for households heads working without remuneration and for heads working in an agricultural occupation and it is lower for households whose head is a small entrepreneur.

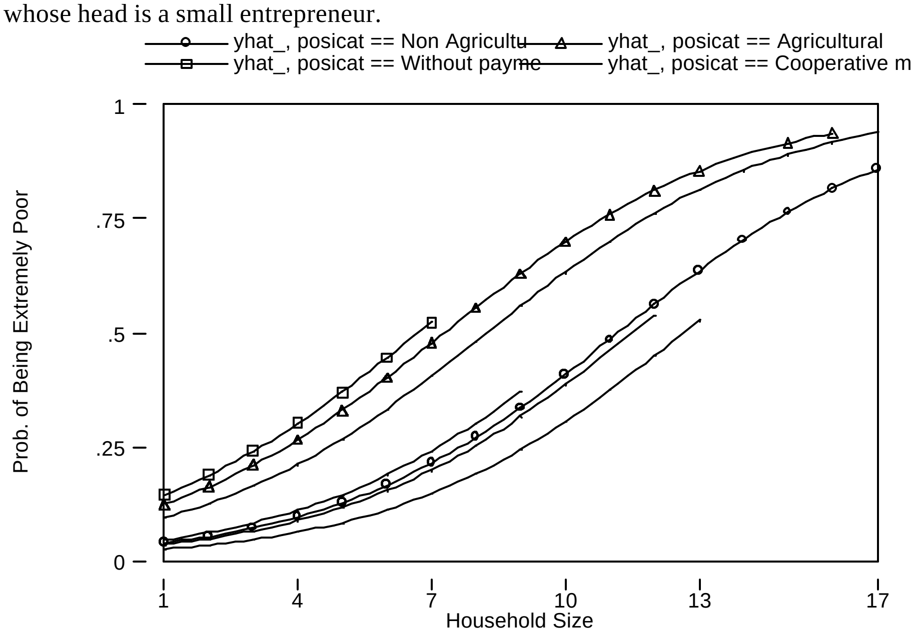

FIGURE 5 PROBABILITY OF BEING POOR AND POSITION IN OCCUPATION

3.9. Poverty and Education

There is generalized evidence in household surveys and censuses that education is positively correlated with earnings [Schultz (1988); Psacharopoulous (1985); Blaug (1976)]. Higher earnings in turn are associated to lower poverty levels.

Education increases the stock of human capital, which in turn increases labor productivity and wages. Since labor is by far the most important asset of the poor, increasing the education of the poor will tend to reduce poverty. Thus, we might think of low education as one of the most important causes of poverty. In fact, there seems to be a vicious circle of poverty in that low education leads to poverty and poverty leads to low education. The poor are not able to afford their education, even if it is publicly provided, because of the high opportunity cost that they face. Many times they cannot attend school because they have to work to survive.

Both Székely [1998] and Cortés [1997] found that education is negatively correlated with poverty in Mexico. Székely reaches the conclusion that education is the single most important factor in explaining poverty in the country. The regression estimated in this chapter also finds that education has a significant effect on the probability of being poor.

Fig. 6 shows the effect of the level of education on the probability of poverty, assuming that the other independent variables take the following values: the household head is 43.9 years old, the household head is male, the household is located in a urban area, and the household head occupation is "not agricultural worker".

Fig. 6 shows that the probability of being poor decreases as the level of education increases.

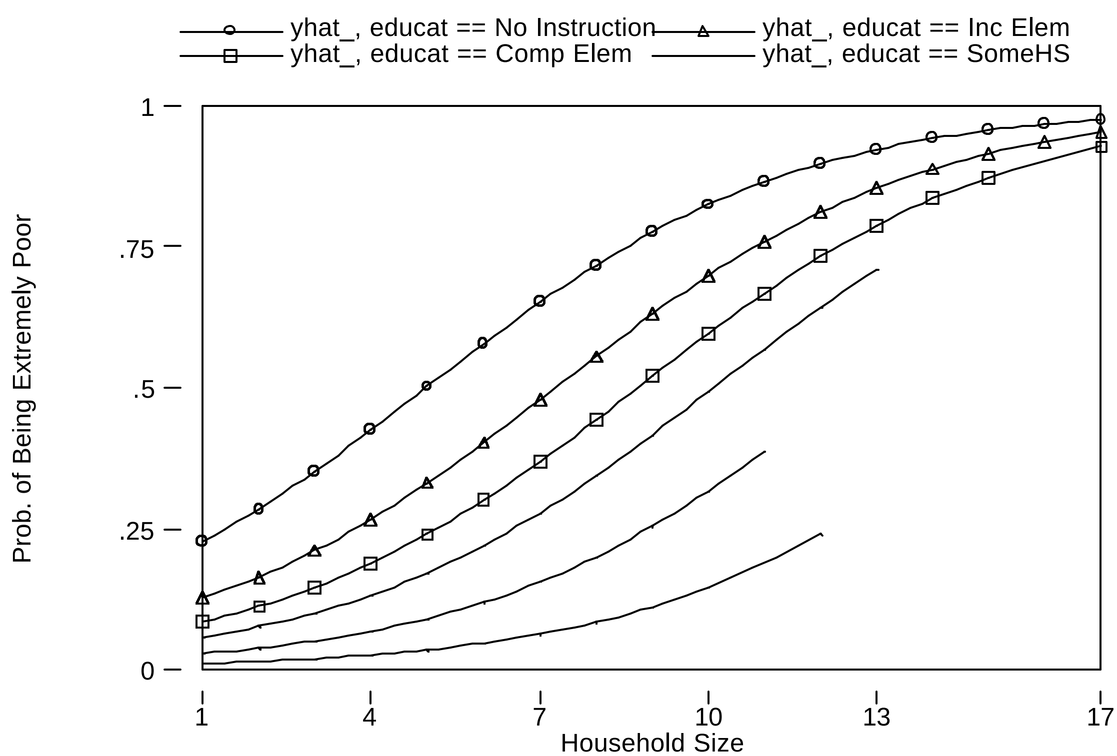

FIGURE 6   PROBABILITY OF BEING POOR AND EDUCATION

3.10. Summary of Findings

The estimates from the logistic model estimated in this chapter indicate that the probability of poverty is higher for female-headed households, for households whose head has a low level of education and for households located in rural areas. Other variables that increase the probability of being poor are the size of the household and if the household head works in agriculture or is self-employed.

4. Conclusions

Reflecting the results obtained by Garza-Rodriguez [2000] in the construction of poverty profiles, the multivariate analysis developed in this study shows that the variables that are positively correlated with the probability of being poor are: size of the household, living in a rural area, working in an agricultural occupation, having a female household headship, having a not remunerated occupation and being self-employed.

The multivariate analysis shows that increases in educational attainment have an important impact on reducing the probability that a household is poor. The five binary variables for education representing increasing levels of educational achievement show that as educational achievement increases, the probability of being poor decreases.

The logistic model shows that a rural family has a high probability of being poor. Even when controlling for education, the size of the household, and the other independent variables in the regression equation, the rural/urban variable is statistically significant and this variable increases the odds of a household being poor significantly. We can only speculate what factors, in addition to poor education and a large household, result in rural poverty. The migration from rural to urban areas is probably selective of the most ambitious and entrepreneurial persons, leaving the less ambitious and less entrepreneurial household heads in the rural areas. These household heads are more likely to be poor.

Government policy also may contribute to rural poverty beyond the effect of poor education by providing fewer resources to rural residents for services such as medical care and by policies that reduce the incentives to increase agricultural production. Poor medical care, which includes problems in the delivery of contraceptive supplies and services, may contribute to the larger household size in rural areas [Chen, Jain-Shing A.; Hicks, W. Whitney; Johnson, S.R.; Rodriguez, Raymundo C., 1990].

Suggestions for further research include the construction of poverty profiles at the state and regional levels, but this task could only be possible if INEGI expands the ENIGH Surveys to make them representative at the state and regional levels. Likewise, the availability of panel data is badly needed in order to be able to construct better models of the determinants of poverty in Mexico.

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Urban Health Insurance System Reform in China

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Abstract

In 1998, the Chinese government began to carry out the urban health insurance system reform program nationwide. The contents of this article can be divided into four parts: first of all, a theoretical discussion is given about the reasons why the government attach importance to the medical insurance system reform; secondly, a description is given about the historic background and detailed contents for China's urban health insurance system reform; and finally, an analysis is given about the existing problems in the process of China's urban health insurance system reform, including the increase of medical expenses, the increase of personal health expenditure, and risks of the medical insurance fund, etc. This article concludes that in order to minimize consumers' health risks, it is necessary to further improve the urban health insurance system.

1. Introduction

In 1993, the State Council of China decided to initiate a reform program on the Government Insurance Scheme and Labour Insurance Scheme in China that had been in existence for over 40 years, and to implement an urban health insurance system. On January 1, 1995, the State Council started the experimental health insurance reform program in some cities. In 1998, the Chinese government began to carry out the urban health insurance system reform program on a nationwide basis.

The contents of this article can be divided into four parts: first of all, a theoretical discussion is given about the reasons why the government attach importance to the health insurance system reform; secondly, a description is given about the historic background and detailed contents for China's urban medical insurance system reform; and finally, an analysis is given about the existing issues in the process of China's urban medical insurance system reform, including the increase of medical expenses, the increase of percentage of the medical expenses paid by individual consumers, and risks of the medical insurance fund, etc. This article concludes that in order to minimize consumers' risks in the area of medical services, it is also necessary to further improve the urban medical insurance system.

2. Reasons why the government attach importance to the health insurance system reform-a theoretical review

Unlike other products such as foods, houses, etc., medical services have unique requirements with the following characteristics [5]: Firstly, the demand for medical services is discrete, sporadic, and unpredictable, so it is very hard to make sure that you have the ability to pay when you need to buy the medical service; Secondly, for consumers, especially those consumers who are inpatients or suffer chronic illness, the cost of the health care service may be very expensive; Thirdly, many poor people do not have the ability to pay for medical services, however they have greater needs for medical services due to the fact of their lower level of living standard, lack of proper nutritional elements, etc. Sometimes, an illness can result in a poor man completely losing the capacity of making a living.

Given the special nature of the medical services demand and the fact that most consumers are risk averse, [3], it is necessary to provide consumers with health care insurance policies to help them spread and share the risks and increase their expected utility.

In reality, governments of many countries carry out reforms on health insurance systems primarily for three major purposes: to reduce the risks of consumers, to utilize the resources more efficiently, and to achieve the goal of equity.

2.1 Reduction of consumer risks

The health insurance system can reduce the payment risks of consumers, because a health insurance policy can help consumers spread the risks over their life time and avoid the situation that they have to make payment in a lump sum; and on the other hand, the health insurance system can pool the risks among members of our community so that risks can be shared between the young and the old, the poor and the rich, the relatively healthy population and the relatively unhealthy population.

2.2 Market failure in the health insurance sector

The existence of information asymmetry is the major factor that leads to market failure. Firstly, the existence of information asymmetry can cause moral hazard [2].

Moral hazard is primarily reflected in two aspects. On the one hand, since the signing of an insurance policy contract is based on the health expenditure rather than the health needs of the people, some consumers may have an incentive to over-consume medical services after purchasing their insurance policies; on the other hand, some consumers may, after purchasing their health insurance policies, lack the protective precaution awareness and behavior to prevent risks from happening, thus leading to increased likelihood of risks taking place. The presence of moral hazards can force the insurance companies to reduce the supply of health insurance, thus leading to the result that the supply of health insurance cannot reach the Pareto optimum level.

Secondly, the existence of information asymmetry can cause adverse selection [1]. The individuals facing the insurance companies could be classified into two groups: the high-risk individuals (greater possibility of getting ill and more finance risks) and the low-risk individuals (they show smaller possibility of becoming ill and less finance risks). When there are several insurance policies available on the marketplace, the insurance companies can charge higher prices against the high-risk individuals and charge lower prices against the low risk individuals, all individuals will have some health insurance. However, when there is only one health insurance policy available on the marketplace, the insurance companies can only set up a same universal price against individuals having different levels of risks. As a result, individuals with low risk will have to exit the insurance market, and insurance companies will also likely incur losses. In reality, governments of many countries will provide the high-risk individuals with some health insurance programs.

2.3 Equity

Different people will face different health risks, the people facing greater health risks will need more medical services, thus resulting in a reduction of their available budget set. In practice, uniform pricing of insurance policies across individuals can make redistribution from low risks to high risks. Of course, if private insurance companies impose uniform prices, adverse selection will be inevitable. In this case, intervention by the government will be necessary.

3. China’s urban health insurance system reform

3.1 Background of China’s urban medical insurance system reform

China’s urban medical security system was originally established during early 1950’s.

In 1951, China began to implement the Labor insurance Scheme1, and the purpose of this scheme was to cover the health insurance for the workers at state owned enterprises and their dependents. All the medical expenses incurred were completely reimbursed by their employers.

In 1952, China began to provide the Government Insurance Scheme for government employees, university teachers and student2 The Government Insurance Scheme was government-financed insurance and people covered by it can get free medical services.

Strictly speaking, both Government Insurance Scheme and the labour Insurance Scheme are only welfare systems instead of insurance systems. During the early years after the birth of new China, the two schemes had indeed allowed some urban consumers to enjoy free or cheap medical services. By the end of 1997, there were about 178 million people covered by the Government Insurance Scheme in China.3

As time moves on, however, the drawbacks of the schemes become exposed. First, the goal of equity could not be achieved. The coverage is limited both in the Government Insurance Scheme and in the Labour Insurance Scheme. By 1993, there were only 172 million people across China covered by the Government Insurance Scheme. A large number of the urban population had to pay medical services out of their pocket.

Furthermore, given the significant differences between individual enterprises in such areas as the industry characteristics, number of workers, and operating conditions, the finance burdens of different enterprises are different, and the workers' wage rates are also different. For some enterprises with deficit, it was becoming increasingly difficult for them to pay the medical bills for their workers.

Second, the moral hazards became prevalent. As a universal health care financing system, the free medical service system and the labour medical insurance system allowed consumers to obtain medical services for free. As a result, the moral hazards became prevalent. People had incentives to over consume medical services. When a person was covered by one of the two systems, all the family members could have a chance to get free medicines. This not only led to the waste of the medical resources, but also increased the financial burdens on both the government and the enterprise.

During the period 1978-1997, the medical costs of workers in China increased from 2.7 billion yuan RMB to 77.4 billion yuan, showing a sharp rise of 28 times and an annual growth of about 19%, while the nationwide financial revenue during the same time only increased by 6.6 times, equivalent to annual growth of roughly 11%. The growth speed of medical costs of workers had been faster than that of the financial revenue.4

In order to solve the above problems mentioned above, the State Council in 1993 decided to reform the two insurance schemes, and implement a health insurance system for urban employees. On January 1, 1995, the Chinese government carried out an initial experimental reform program in areas like Zhenjiang City, Jiangsu Province, and then in 1996 further expanded experimental reform programs in 56 cities around China. In 1998, the State Council issued the "Decision of the State Council on Establishing the Basic Medical Insurance System for Urban Workers", started a nationwide reform on the urban health insurance system.

3.2 Main contents of urban health insurance system reform

According to the "Decision of the State Council on Establishing the health Insurance System for Urban Employees" issued in 1998, the urban medical insurance system reform in China primarily includes the following contents:

First, the goal of reform is to make all the urban employers and their employees to participate in the basic medical insurance system, and to provide the primary medical services for urban consumers.

Second, both the employers and their employees should pay for the health insurance premium. The ratio of payment by the employers will be about 6% of employees' wage income, and that by their employees will be basically 2% of their wage income.

Third, the health insurance fund will be comprised of the social insurance fund and personal medical saving accounts. The premium paid by employees will be entirely debited into their personal saving accounts. The premium paid by employers will be divided into two portions, where one portion will be used to establish social insurance fund, and the other portion will be debited into personal medical accounts. Both the principal and interests of medical accounts will belong to the ownership of individual employees, and can be settled, transferred, utilized, and succeeded.

Fourth, the reimbursement standard and the maximum reimbursement limit of social health insurance fund are set. Medical expense will be paid by medical saving account or out of employees' pocket when it is below the reimbursement standard. The medical expense both above the reimbursement standard and below the maximum reimbursement limit will be mainly paid from the social health insurance fund ,and the employee will also need to undertake a certain percentage. The medical bills greater than the maximum reimbursement limit can be resolved and paid through other means like commercial insurance providers.

Fifth, retired employees who are now members of the medical insurance system don't need to pay any medical insurance premium.

Sixth, it is allowed to establish complementary medical insurance programs in enterprises. The new urban workers-oriented medical insurance system allows more people to have the chance to participate in the social medical insurance system, and can resolve the moral hazards problem to a large extent. By the end of 2002, many cities and towns in China implemented the medical insurance system, which was participated in by 94 million people, including 69.26 million in-service employees and 24.74 million retired workers,[5] amounting to 37.9% of urban employees and 18.7% of urban population in China.[6]

4. Some comments on China's urban health insurance reform

China's urban insurance system is not perfect, and there are some shortages with it. First: the number of people covered by the urban health insurance system is limited. At present, there are still a large number of urban people not being covered in the urban medical insurance system, so they have to pay their medical expense out of their pocket, and have to face and undertake big health risks. The people not covered by the urban medical insurance system primarily include the following four groups: Employees' dependents and students; Workers under formal employment conditions, such as township enterprises and their employees, people work in the urban private enterprise, etc., which are usually not covered in practical although they indeed are within the coverage according to governmental regulations; Workers at some state-owned enterprises with financial deficit, some of them are not covered in the system due to their inability to pay the premium, although they are indeed within the coverage; Urban residents covered by the minimum income assurance program according to relevant regulations.

Second, since the reform on the medical insurance system has not changed the traditional fee-for-service practice, medical expenditure rises rapidly.

Doctors know more information than consumers do on the reasons of an illness, the effectiveness of the treatment plans, etc. In this case, the method of payment for medical services will to a large extent affect the medical expenditure. In China, most hospitals have been pursuing the fee-for service practice, which entices both hospitals and doctors to generate the motive to increase supply of medical services and make more money. This leads to the phenomenon of doctor-induced demand, i.e. the doctors attempt to increase their own income by prescribing some simply unnecessary medicines or expensive medicines or recommending the patients to do some unnecessary expensive examination.

For example, the average medical expense per outpatient in general hospital of Health Sector increased from 39.9 yuan in 1995 to 99.6 yuan in 2002, showing a growth rate of 149.6%; and the average medical expense per inpatient in general hospitals of health sector increased from 1667.8 yuan in 1995 to 3597.7 yuan in 2002, growing 115.7%.[7] Table 1 shows the consumer price index and the price index of medical services in China.

TABLE 1 CONSUMER PRICE INDEX (PRECEDING YEAR=100)

	1995	**1996**	**1997**	**1998**	**1999**	**2001**
Consumer Price Index	117.1	108.3	102.8	99.2	98.6	100.7
Medical Articles	111.3	109.3	104.7	102.8	100.9	100.3
Health Care Services	111.1	112.4	122.9	117.2	111.7	110.5

Resource: National Statistics Bureau in China

As shown in Table 1, the consumer price index has been initially increasing year-on-year since 1995, but the annual growth rate is less than 8%. Since 1998, the consumer price index began to decrease, and did not gain any slight rise until 2001; however, the price index of medical services has been increasing each year at a growth rate over 10%, and even gained a sharp rise of 22.9% in 1997 than that of the previous year.

From mid August 2002 to the end of October 2002, in order to obtain a true understanding about the comments and evaluations of Chinese residents on the prices of medical services, the China Economic Prospect Monitoring and Measurement Center did a questionnaire survey on over 700 permanent residents in Beijing, Shanghai, and Guangzhou. 66.8% of the consumers surveyed believed that the current prices of medical services were relatively higher; 17.6% and 65.8% of all respondents were very worried or worried about the high expenses they will have to pay in the future for medical services and medicines[8]. Obviously, the increasing prices of medical services and the increasing medical expenses have already become an important consideration that consumers are increasingly worried about.

Third, the personal health expenditure rises rapidly. In the Government Insurance Scheme and the Labour Insurance Scheme, consumers did not need to pay any or only needed to pay a little medical expense. In contrast, the consumers covered by the urban medical insurance system will have to pay more for medical services. On the one hand, this will reduce “moral hazards” problem of excessively abusing medical services resources. But, one the other hand, this will lead to more economic burdens on the consumers with lower wage income, especially the outpatients with the chronic illness (according to the regulations in many cities, the outpatient expenses have to be paid out of their medical accounts or directly out of their pockets) and inpatients with severe disease.

As shown in Table 2, since the 1990’s, the percentage of personal health care expenses in the overall health care expenditure has been rapidly increasing. In 1995, the total expenditure of personal medical expenses in China was 34.52 billion yuan, amounting to 38.8% of the total expenditure of medical expenses; in 2001, the total personal medical expenditure was 311.33 billion yuan, amounting to 60.5% of the total expenditure of medical expenses.

TABLE 2 HEALTH EXPENDITURE IN CHINA

	1991	1995	2001
Total Health Expenditure (100 million yuan)	888.6	2257.8	5150.3
Government Health Expenditure	202.3	383.1	800.6
Social Health Expenditure	341.1	739.7	1236.4
Personal Health Expenditure	345.2	1135.0	3113.3
% of Health Expenditure	100.0	100.0	100.0
Government Health Expenditure	22.8	17.0	15.5
Social Health Expenditure	38.4	32.7	24.0
Personal Health Expenditure	38.8	50.3	60.5

Resource: Ministry of Health in China

Today, China is still a developing country, and the income of Chinese people is still low. The implementation of personal medical accounts can only work as a mechanism for risk spreading rather than for risk pooling. The increasingly growing personal expenditure is therefore much more against the original purpose of reducing risks with the social insurance system.

Fourth, the aging population is bringing risks to health insurance fund in China. At present, many people covered by the urban health insurance system in China are old people. The reasons can be divided into two aspects: First, the life expectancy of the Chinese population continues to become longer in line with growth of the social economy, improvement of people’s living standard, and advances of medical technology, thus leading to the quite significant phenomenon of aging population. The percentage of the elderly people aged 65 and above in the total population increased from 4.4% in 1953 to 7% in 2000, as shown in Table 3.

TABLE 3 NUMBER OF POPULATION ON NATIONAL POPULATION CENSUS

	1953	1964	1982	1990	2000
Mainland in China (million people)	582.603417	694.581759	1008.175288	1133.682501	1265.830000
% of Population By Age Group					
0-14	36.3	40.7	33.6	27.7	22.9
15-64	59.3	55.7	61.5	66.7	70.1
65+	4.4	3.6	4.9	5.6	7.0

Resource: National statistics bureau in China

Second, the percentage of in-service employees covered by the insurance policy continues to decrease relatively, in line with the deepening reform on the corporate ownership system and the adjustment of the industrial structure, which have resulted in restructuring, reorganizations, mergers, and even bankruptcies of some state-owned enterprises, thus further leading to early retirement of some active workers and employees and increase of the unemployed people.

In Zhenjiang City, for example, which is one of the first to implement the experimental reform program on the medical insurance system, from 1995 to 2001, the percentage of active employees covered by the total insurance policy dropped from 79.92% to 71.63%, while the percentage of retired workers and employees rose from 19.01% to 27.4%.9 It is worthy of notice that the absolute number of active workers and employees also decreased from 216644 people in 1995 to 200152 people in 2001.

TABLE4 NUMBER OF WORKERS PARTICIPATING SOCIAL INSURANCE IN ZHENJIANG CITY

	1995	1997	1998	1999	2000	2001
Total people (thousand people)	273.583	279.333	275.112	262.284	263.882	279.423
In-service workers (thousand people)	216.644	218.146	210.324	197.065	194.560	200.152
% of total people	79.2	78.1	76.45	75.13	73.73	71.63
Retired workers	52.011	58.283	61.976	62.429	66.601	76.564
% of total people	19.01	20.87	22.53	23.80	25.24	27.40

The number of retired workers continues to increase, and this will create a negative impact on collection of the money for the medical insurance fund, because it is the active workers and employees who are paying premium for the medical insurance fund and retirees do not need to pay anything for this insurance fund in China. on the other hand, this will also cause the demand for the medical insurance fund to grow, because retirees have a higher incidence of diseases. This will pose very great pressure and risks on the income and expenses of the medical insurance fund. In 2001 alone, a total of 48.42% of the total medical insurance fund was used by those retirees in Zhenjiang City who amounted to only 27.67% of the total insurance policy subscribers population, as shown in Table 5.

TABLE 5 ZHENJIANG CITY 2001 MEDICAL EXPENSES STRUCTURE

	Total medical expenses	Medical expense per capita	Expense Structure (%)	Population Structure (%)
In-serviceworkers(yuan)	134713666	673.05	51.58	72.33
Retiredworkers(yuan)	126457399	1651.66	48.42	27.67
Total(yuan)	261171065	943.82	100.00	100.00

It is necessary for the government to expand the coverage of urban health insurance and to allow more young people to take part in the social insurance program in order to make the social insurance system work better.

5. Conclusions

The key objectives of health scheme in a country include: to introduce and establish a medical services utilization system that is highly efficient in the community; to pool risks among the individuals; to spread risk in the life time of a person; and to allocate resources as needed.

Today, the reform on the medical insurance system for urban workers and employees in China can not share and spread risks for consumers very well, and there exists fund risks. The government should expand the coverage of the insurance policy, allow more urban people, especially young people, to be able to participate in the health insurance system. The governments should also design and develop different health insurance policies to meet the needs of different people.

References

Contact the author for the list of references.

End Notes

1 Based on the "Regulations of the People's Republic of China on Labour Insurance" issued and implemented by the previous Government Administration Council.
2 Based on the "Instructions on Implementing the Free Medical Services and Preventions System for State Staff Workers at All Levels of People's Governments, Parties, Associations, and Affiliated Public Institutions Nationwide" issued and implemented by the previous Government Administration Council.
3 News Background: China's urban workers-oriented medical insurance system reform, reported by PAN Shantang, Xinhua.net
4 Year 2002 Labour and Social Security Program Development Statistics Bulletin, the Ministry of Labour and Social Security, National Bureau of Statistics.
5 National Bureau of Statistics 2002
6 Source: Ministry of Health 2003 Statistics Abstracts
7 China Economic Prospect Monitoring and Measurement Center (2002-09-29)
8 The statistics data about Zhenjiang comes from the paper "Effect of Aging Population on Medical Insurance", Li Yiping, "Zhenjiang Medical Reform" magazine, Issue 4, 2003.
9 Other insurance policy subscribers are retired officials and wounded and handicapped people.

Industry Strategy Meets Civil Society in Asia: Confronting Regulation of Cross-Border Media

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Abstract

In many post-colonial countries, domestic television has long neglected cultural minorities which transnational television subsequently successfully targeted. Characteristically, governments in Asia have sought to dominate domestic television and control access to transborder television out of nationalism and paternalism. But audiences and entrepreneurs have circumvented such policies, aiding the phenomenal growth of the cross-border medium. Over the 1990s the domestic television industry throughout Asia was transformed by this new competition, and belated media deregulation seems to have led to alliances between big business and political power. This paper seeks to demonstrate that such developments have been primarily commercially and technology driven, and calls for a greater role of public ethics and civil society in formulating media policy.

Introduction

Many Asian governments view the state as constituting or at least incorporating civil society, and thus co-opting its socio-political groupings in a paternalistic manner. The media then are seen as subservient to the cause of nation-building as defined by government, and in many countries domestic public television was pressed into service of this cause. Even satellite television was harnessed to reach the remote corners of far-flung national territories nationalistic development programming. Thus most governments in Asia have felt threatened by the advent of transborder television and endeavoured via various means to control access to it. The countries most threatened were those which had the strongest ideological commitments to national cultural and political integration, and/or centralist social and economic planning.

Realising that their various current media regulations had failed to achieve sufficient control over citizens' access to foreign broadcasts, some governments have gone on to make concessions towards or to collude with the transnational satellite broadcasters. While some other countries simply conceded defeat by default, a rare few have welcomed the newer media, even fostering thus the renaissance of civil society last seen in their struggle for independence from colonial powers. Deregulation of the media is one of the key symptoms of the relentless economic and political globalisation that has been much in evidence in Asia as worldwide at the turn of the 21st century. Consequently there has been abdication of control by government to private enterprise, whether national or transnational. Given the latter's agenda of targeting audiences via palatable content to advertisers, there seems little promise of it nurturing, much less championing, civil society in Asia.

Framing the Issues

The notion of civil society draws from rich traditions in Western political philosophy dating from the 18th century concerning the existence of a social collectivity beyond the state. Naturally it has gained a new momentum in the post-Cold War era brought about not by confrontations between opposing states, but the undermining of nation-states by non-government social movements. In Central Europe, civil society even came to provide the legitimacy for new post-communist governments, while being rediscovered in Western nations where it was assumed to be sustained by democracy, yet has been eroded by institutional politics. Thus Seligman (1992) presses for a contemporary renaissance of the core concept of an ethical vision of social life independent of the state, amidst competing definitions of civil society towards the end of the 20th century. Yet the idea of commonality is difficult to reconcile with the ethnic heterogeneity in Central Europe or individualism of Western societies. Taking a Marxist perspective that this an over-reaction to the theory of the state, Neocleous (1996) argues that the distinction between state and civil society is false, if not redundant, citing Foucault in support of his view. Schecter (1994) elaborates that Marx saw production as the primary activity of civil society and advocated democratic decision-making in the local workplace so as to reconcile the roles of citizen and worker. Leninist-Stalinist objectives of rapid industrialisation led to the melding of capitalist forms of organisation with socialist planning. But the consequent mismanagement, bureaucracy, repression, disenfranchising of the people and eventual downfall of communist societies, the answer lies neither in free-market capitalism, social democracy nor market socialism. Schecter believes that social democracy is incompatible with capitalist production and that what is needed is a democratically-controlled economy within civil society. If this is also based largely on local-scale production and community control with transparency and consultation, there is hope no-growth economies, reduced consumption and ecological sustainability

In much of present-day Asia, as in Eastern Europe of the past, civil society is subsumed under the state as the site where the contradictions of individual freedoms and social order are reconciled. Since gaining their independence from colonialism in the 1950s and 60s, most countries were concerned about maintaing tight control over all areas of the nation. As such, the media, often public or private were co-opted into the service of the nation-state, rather than being allowed to be a means by which civil society might influence social-political policy. Characterised as it is by concentration of power, intimidation of political parties, restriction on political discourse and media controls, authoritariansim finds the idea of a healthy civil society anathema. In Africa, Healey and Robinson (1992) found little evidence of public policy resulting from competitive lobbies for resources with the state providing a neutral arena as in the West. Even when authoritarian regimes were gradually replaced in Latin America, Africa and Asia, democratisation of the media was not as forthcoming as the expanded media were often under the control of businesses driven by market imperatives if not also the agenda of political-economic elites.

The dominant capitalist ethic in the world economy values primarily the financial utility of socio-political organisation and economic exchange as measured by market prices. Famed for advocating of free-enterprise, economist Friedman (1981) argued that corporations inevitably act morally when they seek to maximise profit within the law and ethical norms overseen by a benign government. But this normative stockholder theory has not been borne out in recent times, and is far from the only alternative in business ethics. In a dissenting opinion, Freeman (1997) believed that corporations have responsibilities not just to their shareholders but all other stakeholders. These include customers, employees, communities and other individuals and groups to whom the corporation has a moral duty which he believed ought to be made a legal obligation by society. But in Humber's (2002) view, this approach provides little direction to corporations faced with the problem of identifying stakeholders and evaluating relative claims to priority. The stakeholder issue is even more problematic in the context of the transborder broadcast industry where it might include global include advertisers, program producers, ratings agencies, conglomerate shareholders, business alliance partners, community/citizen groups, non-government organisations, government departments and media-cultural policy-making bodies among others.

Dependency in Development

Under early space treaties the benefits of outer space were meant to be shared by all countries, in reality they have accrued largely to developed countries rather than the developing countries. This is because the former's commercial satellite businesses often applied pressure via their governments on the ITU, as regulator of global telecommunications, for satellite orbital slots. Besides it is difficult for ITU to allocate slots equitably because there are multiple users of each commercial satellite, each of different corporate citizenship, and also because some territories such as Hong Kong are not signatories to the space agreement. Countries like Indonesia, India and China which have used their own satellites in their assigned orbital slots to enhance their social and economic development are well within their rights. But many other countries, such as the Pacific island nations, are in no position economically to utilise effectively any slots they are entitled to but are often persuaded by business interests in the West to lobby for slots and then sublease these to them for commercial television and telecommunications purposes.

Even before the era of transnational television, communications satellites for national development purposes were recommended to the governments of Third World countries. This was done in India and Indonesia by First World governments or their surrogate IGOs, usually at the lobbying of their MNCs. But the purported benefits of national integration, administrative effectiveness, provision of educational services and of news/information, and their deliverability, may be questioned. For it is doubtful whether the medium of domestic satellite television could realistically overcome the need for local autonomy, bureaucratic centralism and inefficiencies inherited from colonial powers, and general deficiencies of finances, trained personnel and support equipment which are often characteristic of developing countries. Extensive research funded in the 1970s and 80s by the governments and their donors/sponsors did seem to reveal some positive social and economic change with the use of satellites. But the reality was more often that the somewhat minuscule change might have been achieved more cost-effectively by alternative communications media, including less glamorous traditional forms. The low cost of the latter though would have meant they could be utilised by various civil society groups and less amenable to control by the national government. So even the public broadcasters of Asia were in a dependency relationship with the First World and its MNCs for technology, well prior to the arrival of commercial transnational television via satellite and cable.

Controls versus Concessions

National governments are by their very definition nationalistic and therefore invariably fear the intrusion into their political environment of transnational satellite television over which they have little influence or control. Based on the perceived threat to its national culture, each country in the East Asia region has sought to adapt in differing ways to the intrusion of transnational satellite television. The controls exercised by governments have ranged from 'active suppression' to 'liberal access', and as evidenced in the case-studies in this book as other publications in the past decade shifts in policy have been made by Asian countries over time. A prime response of Asian governments has been some deregulation of their terrestrial-domestic television industries, as seen in Indonesia, Taiwan and Thailand, either in anticipation of transnational satellite television or in forced response to overwhelming competition from them. Subsequent political upheavals in these countries have seen these newer media play a growing role in civil society as independent information sources, for a for social debate and watchdogs, the proverbial fourth estate. In the more politically conservative countries, the preferred option has been the expansion and diversification of the government-owned or controlled media, as in the PRC, Malaysia and Singapore. While the more liberal countries such as the Philippines, Thailand and now Indonesia seem content to let market forces prevail, others like Korea and Hong Kong have adopted a 'wait-and-see' attitude, though clearly biased towards the more conservative alternative of regulation. In any case government control over access grows increasingly difficult with technological advances, such as greater power of direct-broadcast satellites making dishes for reception smaller and less detectable, and the increased streaming of television broadcasts over the Internet via broadband cable.

The consistent growth in transnational satellite television viewership, in those countries which do permit access to it, does not seem to be at the expense of domestic terrestrial television watching. Neither does advertising revenue for domestic broadcasters seem to be declining in the region, possibly due to the high economic growth among many East Asian nations except for the brief economic crisis in the late 1990s. The effectiveness of transnational satellite television in attracting domestic audiences seems to involve any single factor but the interaction of multiple factors. These include the quality of terrestrial programming versus satellite programming, cultural and linguistic barriers and pathways, access costs for consumers, economic affluence, among many others. Thus regulation may be a poor predictor of the impact of transnational satellite television, in recognition of which many governments in Asia have since deregulated their television industries. While some governments hold on to their regulations or make further pronouncements on control, most of these fail to implement them or try to, except erratically. A union of public broadcasters in the region recommended a set of ethical guidelines for transnational satellite broadcasters (Gunewardena, 1997). This call for respect of social, political and other values of the countries into which they broadcast has been largely ignored as irrelevant. With few exceptions this quasi-liberalisation in East Asian nation-states seems motivated by their push for integration into the capitalist world-economy and resignation to massive technological change in communications, rather than enlightened concerns for providing independent information, public media space or freedom of expression to diverse social groups within their societies.

Cosmopolitan or Contextualised

Transnational broadcasts in world languages such as English which StarTV provided initially and which BBC or CNN continue to are able to attract only minuscule audiences across Asia. These comprise largely expatriate executives or an urban cosmopolitan elite who are able to relate to the content and be comfortable with the language. In contrast, domestic television channels, whether public or commercial, tend to attract far larger audiences in any single Asian country than pan-Asian ones via satellite, with very few exceptions. This is simply because any country's cultural milieu invariably affects the role that television plays in it and its appeal to particular segments or the broader population. Transnational satellite broadcasters such as CNBC, HBO and Discovery realised quite soon after their entry into the Asian market that in order to command significant audiences in each country and thus attract advertisers, they had to localise or at least culturally contextualise their programming somewhat. Domestic broadcasters then discovered that in order to beat the transnationals or at least not suffer significant erosion of their audiences, they had to upgrade the quality of their locally-produced and imported programming. Another strategy was to provide or emphasise sub-national ethnic programming which the transnationals may not have expertise in doing. This is something that public domestic broadcasters have been averse to doing, as in the case of DD in India, CCTV in China or TVRI in Indonesia, because of their political mandate as public broadcasters to promote national cultural integration. The more established domestic commercial broadcasters also saw little need to in their pursuit of audience shares in a mass market, although some latter domestic commercial broadcasters and the public broadcaster DD in India have found success in catering to niche language and cultural audiences.

Transnational satellite television took off in the urban metropolitan areas of India and Taiwan because it was compatible with pre-existing practices of watching unregulated cable television. Hence the new medium could be trialed at low cost in contrast to the situation in Indonesia and Hong Kong for instance, where expensive satellite dishes or pay-TV cable had to be installed. Furthermore, transnational satellite television programming represented a quantum leap in quality over the existing programming fare on domestic television in these countries. So it represented a relative advantage to potential adopters who could observe this for themselves in advance through their social networks. Early adopters of transnational satellite television in all of these countries were culturally 'cosmopolitans' rather than 'locals', and generally financially better-off. Since it has spread to the rural towns of Asia where the audiences are largely represented by small entrepreneurs and/or landowners, a process doubtless aided by the increasing cultural contextualisation of the programming and breadth of channels. Whether transnational satellite television will become the medium of choice for the wider civil society has yet to be seen, though that is somewhat in doubt.

Symbiosis amidst Plurality

Any listing of the major transnational television broadcasters and satellite platforms in Asia at the turn of the 21st century makes quite evident that the field is dominated by MNCs, whether regional or global. Even where the satellites are owned by national governments or corporations owned by them, as for instance Indonesia's Palapa satellites, or IGOs such as Intelsat, most of the television channels they carry are commercial and owned by domestic and transnational broadcasters, a trend that continues unabated. Other satellites are owned or part-owned by regional or domestic conglomerates, such as AsiaSat, Apstar, Thaicom and Measat satellites. With few exceptions such as the cases of India and China, the satellites are constructed by First World MNCs to the specifications of their Asian owners and their potential broadcaster clients, and launched at facilities owned by First World governments or consortia of them. Some satellite owners and even manufacturers are diversifying into the business of programming and channel establishment, in other words expanding from hardware into software. Although on the surface, broadcasters from within the Asia region are holding their own against the transnationals, even beating them at their own game, the reality is of continued domination of the industry's hardware and software markets by MNCs from the First World. In any case most of the domestic or regional broadcasters or satellite owners have connections with or participation by government, dominant political party, armed forces or other important domestic power bases. As such they are not necessarily vehicles for reflecting the aspirations of the various societies within the nation-state.

Despite their sometimes competing business agendas and unwillingness to acknowledge dependence on one another, a symbiotic relationship could be said to exist between transnational satellite channels and domestic cable television networks. Redistribution of television signals to cable networks was the first major use of satellites to be made by the television industry in the US and continues to be a prime factor in the utilisation of broadcast satellites in Asia. Often the growth of ad hoc, localised and unregulated cable networks are symptomatic of the civil society's rejection of the government's political or cultural hegemony via the media. Extensive pirating of signals by individuals and illegal cable operators using satellite dish-antennae in countries such as Taiwan and India, has necessitated the scrambling of signals by many transnational satellite broadcasters in Asia, and again involves utilising technologies patented and so controlled by Western corporations. Although technology for direct broadcast satellites (DBS) has been in existence for decades and in Asia for half a decade now, it has not gained widespread acceptance in the marketplace due to the higher cost of reception via satellite dishes for consumers. Some Asian countries such as Singapore, Indonesia and Taiwan have adapted cable television for pay-TV purposes in their attempts to regulate access to transnational broadcasts. But usually these government attempts to regulate the multitude of small domestic cable networks have been via issuing a limited number of licenses. The resultant industry consolidation has usually opened the door to foreign MNCs to form multi-service operations (MSOs) in joint-ventures or strategic alliances with domestic or regional corporations, medium or large, usually with strong political and economic ties within each country.

Reflections and Discussion

Most national cultural policies devised by paternalistic governments are driven by fears of Western cultural homogenisation, or more specifically 'Americanization', as much in Asia as in Europe, Latin America and Africa. Liberalisation of media industry has been a concomitant of political change as evident most dramatically in Taiwan, Indonesia and Korea, and less so in many other countries (Kitley, 2002). Although East and South Asia did not have the extensive civil society-led revolutions of Eastern Europe, the television industry has undergone a significant transition of sorts, largely commercially and technology driven. Increasingly, policy-makers in Asia have come to recognise that their countries cannot develop without contact with other cultures, and so urge the reinforcing of their own cultures through producing quality television programs domestically to counter consumerist influences of transnational programming. But then their upgraded domestic television programming is often a clone of the global, and no less consumerist in its values, or culturally imperialist in other ways. Furthermore, programming directions on domestic television channels sometimes reflect the cultural hegemony of the country's urban politico-economic elite drawn from a dominant ethnic or minority subcultural group within that country. In other words, there is often as much media imperialism exercised within a country than from without.

It remains unclear whether morality can be legislated and what ethical system should adopted in multicultural developing countries such as those in Asia. Christians et al (1991) advocate a framework for ethical reasoning in the media but acknowledge its dependence on largely Western traditions of moral philosophy. Vogel (1996) bemoans the fact the focus of much research has been on the role of civil society on government policy, while tending to neglect its effect directly on corporations. In a global economy dominated by multinational corporations, Mark-Ungericht (2001) thinks it inevitable that civil society networks will emerge to influence the way business is conducted. While this sort of enforced dialogue has proven ef our issues, there is less evidence of civil society impact in the arena of media diversity and freedoms, particularly fective with environmental and lab against global media corporations as well as government-controlled commercialised media. The cost of utilising satellite television broadcasting is prohibitive to non-government organisations (NGOs) and civil society groups within each nation-state. Though with the increasing de-massification of electronic media, there remains hope that someday it might be possible for transnational social movements to utilise them for broadcast as they already do the Internet.

References

Contact the author for a list of references.

Section 7
Education and Accounting

The Role of International Exchange Programs To Promote Diversity on College Campuses: A Case Study

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Abstract

In response to recent Court decisions, many US colleges and universities are energetically seeking ways to increase the diversity of their student bodies. Through recruitment and other policies, their goal is to develop a student body in which students, as the result of every day interactions with their colleagues, come into contact with individuals with backgrounds that are different from those met through previous experiences. While the focus of many of these university efforts in the US has been the inclusion of greater numbers of native -born, naturalized, or resident minorities in the student bodies, one could argue just as effectively that, given the position of the United States in the global political economy, student bodies should contain significant representatives from countries outside the United States. The purpose of this paper is to discuss the role, development, and implementation of effective international exchange programs involving faculty, staff, and students can play to promote campus diversity using examples from the experience of Southern Illinois University to illustrate key points.

I. Introduction

Ever since the Bakke [6] and subsequent cases involving the issue of the constitutionality of affirmative action programs, colleges and universities have sought ways of developing admissions programs that would permit them to identify, recruit, and admit legally individuals with specific ethnic or other identifiable characteristics. In its majority opinions in the University of Michigan cases (Gratz v.Bollinger and Grutter v. Bollinger), the Supreme Court accepted the Creation of a Diverse Student Body as a legitimate, that is, legally acceptable criteria for establishing admission criteria. [5,6]

The Creation of a Diverse Student Body doctrine argues that a college or university, especially a publicly supported college or university, has a responsibility, perhaps, even a legal duty, to develop and implement admissions policies and criteria that diversify its student population.[1] Admission policies such as that of the University of Michigan which was the subject of the 2003 Supreme Court decision provide explicit consideration of such factors as ethnic background, residence, and proposed major when deciding to accept or reject a prospective applicant. By explicitly considering such factors, the university intends to create a student body in which the typical member, as the result of every day interactions with his or her colleagues, comes into contact, presumably fairly frequent contact, with individuals with backgrounds that are different, sometimes substantially different, from those met through previous experiences. As a result of such exposures in the classroom and less formal settings, the typical student will develop a greater understanding, tolerance, and ability to cope effectively with individuals from backgrounds that are different from those in which the individual was raised and educated prior to his or her attending a college or university.

While the focus of the creation of a diverse student population argument has been on the inclusion of greater numbers of native-born, naturalized, or resident minorities in the student bodies of US college and universities than would occur if special admission programs did not exist, one could argue just as effectively, if not more so, that, given the position of the United States in the global political economy, student bodies should contain significant representatives from countries outside the United States. Further, in order to broaden the educational backgrounds of its student body, a college or university ought to create programs that encourage its faculty and students to spend time outside the United States in order to bring the results of those experiences back to the classroom and other campus activities.

Given that the United States is the world's largest economy, accounting for approximately 15% of global GDP, is the third largest country by population, and, at least at present, the world's only designated superpower with respect to political and military influence, it would seem logical that the curricula of its educational systems would stress the development of cross-cultural and other forms of education that would create a citizenry that was well-versed in its understanding of the cultural, political, and economic systems of the rest of the world. That Business Schools recognize the importance of international issues is evidenced by a recent survey that found that 81% of the participating schools included a specific reference to the international business environment in their mission statements. [2] Of course, there have been so many studies done since the launch of Sputnik that point to the conclusion that the average US citizen knows less about what is happening in the rest of the world than the average citizen of any other developed country in the world. This information is now essentially so well documented that it is accepted as common knowledge.

While many have lamented the narrowness of the US perspective, for most of our history such a national-centric focus has not hindered its leaders and politicians from constructing and implementing fairly effective foreign and international economic policies. That era, however, may be rapidly drawing to a close. The role on the US in a post-Cold War world is not the same as the role played by the US since the end of WWII. In fact, one may have to go back at least the end of WWI or perhaps the 12th Century to find a global political situation such as that which has developed since the fall of the Berlin Wall. The US role in the global economy is also evolving in a way that requires an understanding of the relationships of the US to the rest of the world that has not existed for at least a century. The emergence of the Chinese economy with the likelihood that the US economy will actually be the second largest economy in the world within the next ten years are creating trends and forces of change that few US business and political leaders fully understand. This narrow perspective, however, has consequences that are difficult to predict. In our efforts to rebuild Iraq, a U. S. military noted that the lack of even rudimentary understanding of Middle East politics, cultures, and religions was a real hindrance in doing the small, simple things required to make nation building a success [6]. A recent study by the American Council of Education concluded that the US has a "dangerous" shortage of experts on non-European cultures and that 75 percent of Americans believe that higher education has a responsibility to incorporate global awareness into the college curriculum so that graduates have at least an awareness of international issues, events, and other cultures [3].

Every college or university curriculum has a general education component. The purpose of that general or liberal education component is to provide the knowledge and skills that a college graduate will use as the foundation for his or her ability to function as an informed citizen of the United States for the rest of his or her life. This portion takes up approximately one third to one half of the total credit that one must earn to complete the requirements for his or her degree. The creation of a diversity in the student body can play an important role in supporting the mission of the general education curriculum by permitting the student to apply and see live examples of the concepts and principles discussed in various classes. In a world that is increasingly complex, it would appear that the definition of an appropriately diverse student body would include an adequate number of students who have lived outside of the US. Universities serving geographic areas with relatively low levels of diversity may have to employ a number of strategies to accomplish this goal.

The purpose of this paper is to discuss the role, development, and implementation of effective international exchange programs involving faculty, staff, and students to promote campus diversity using examples from the experience of Southern Illinois University to illustrate key points. The role and importance of such programs is discussed in Part I. The history and nature of the programs offered by SIUE are described in Part II. Conclusions that may be drawn from these experiences are presented in Part III. The effects of recent changes in administration and budgets on the commitments necessary to make such programs work are the subjects of an epilogue to this paper.

II. The Importance and Role of International Exchange Programs in the Curricula of Public Colleges and Universities

In its Bakke and University of Michigan decisions, the Supreme Court stated that colleges and universities have a compelling interest to create diverse student bodies. The interest is so strong that, under carefully defined conditions, it is permissible for colleges and universities to use criteria and methods that, if applied under differing circumstances or purposes, would be illegal.[2] While it is clear that the court intended its remarks to address the issue of the admissions criteria used by colleges and universities, especially those that are supported from state and local government funds, the issue of the what constitutes a diverse student body goes beyond simply assuring that certain minority groups are represented in adequate numbers in the student body of a given college or university.

The first question that must be addressed is: What constitutes a diverse student body? To answer this question, one must first state the university goal or objectivity that is to be addressed by developing a diverse student body. Then one must be define diversity in a way that can be operationalized. This will then determine the groups that one wants represented in the student body and will begin to address the question of what must the distribution of students by category by to achieve the goal of having a diverse student body. Should, for example, the number of Asian-Americans be roughly equivalent to the percentage of Asian-Americans in the state's population or, because the Chinese economy is becoming more and more important to the health of the US economy, should the number of Asians, particularly those of Chinese ethnicity, be such that virtually every student on campus will have at least one class per year with an Asian student?

The answer to questions such as these depends largely on the goal that led the institution to determine that having a diverse student body was an important element in the strategy to achieve its larger goals and objectives. If the compelling interests of the United States that are mentioned in the Supreme Court opinions are related to producing citizens that can function more effectively in the world of the 21st Century, one would argue that a diverse student body is one in which the likelihood of any random student having at least one class per some time period is such that it is virtually certain that the student will have such contact. One can then determine the minimum number of students that one must have in a given category. Once this target or goal has been established, a recruitment, admissions, and retention can be developed to move towards the targets required to create a diverse student body.

In addressing this compelling interest that will be achieved by creating diverse college student populations, exactly what constitutes a diverse student body must be confronted. Does a student body that consists only of US residents from various backgrounds for which targets have been created constitute the diversity that meets the nation's compelling interest? It would seem that the student body ought to reflect the situations that the student is likely to encounter upon the completion of his or her degree requirements.

Given that virtually every business in the United States, regardless of size or location, will either buy goods and services produced in another country, sell its goods or services to some entity in another country, or be owned by a foreign parent, it would seem that a student body that does not have students generated through some type of international exchange program would not have an adequately diverse student body. Most college graduates are going to have contact and have to deal with foreign citizens in order to earn a living even if he or she never leaves the US. Further, can a campus really meet the compelling interest criteria if it does not provide the opportunity for its students to learn and apply their coursework in countries outside the United States? While one would not expect every student to study abroad, at the very least, colleges and universities must provide an environment that brings students into contact with others who have lived abroad in order to build the cross-cultural skills that are needed to be successful in the 21st Century.

This, however, is not the end to the list of questions that must be addressed before one can determine if the campus's student body is adequately diverse. Another question that must be addressed is the question of: Can the student body really be diverse if the faculty is not? In order for the student body to be diverse in a way that meets the Court's compelling national interest, can all students, regardless of their backgrounds, by taught by a faculty that is of a homogeneous background and no international experience? In other words, is a diverse student body sufficient to achieve the national compelling interest associated with diversity?

While the answers to these questions may very from campus to campus, one thing is certain: creating a diverse student body goes beyond simply making certain that there are a certain number of students and, perhaps, faculty in categories that are defined by Human Resources. In answering the questions, it is doubtful that a college or university can achieve its goal of a diverse student body that produces graduates prepared to be effective and employees in the 21st Century without developing an international exchange program that includes opportunities for faculty and staff as well as students.

III. The International Exchange Programs of Southern Illinois University Edwardsville

Southern Illinois University Edwardsville is a metropolitan campus of Southern Illinois University. Located in the eastern part of the St. Louis metropolitan area, SIUE serves the most populous region in Illinois south of I-80. The majority of its students are still first generation college students who come from lower or middle-income families that live and work in counties that are still largely rural. The student body is relatively homogeneous with respect to ethnicity, for 85 percent of the undergraduates are Caucasian/Non-Hispanic and 96 percent were born in the United States. Further, 70 percent indicated that, prior to attending SIUE, they had had little or no exposure to foreign-born citizens.

As was the case with most institutions, one of the earliest offices established by SIUE was an International Student Affairs Office. The primary purpose of this office, however, was to address the needs and concerns of foreign nationals who chose to pursue degree programs at SIUE. Until the late 1980s, there was virtually no interest among the SIUE students in studying abroad nor in foreign students studying at SIUE to complete coursework that would be applied to degrees at a home institution.

This began to change in the late 1980s for the following reasons. First, the American Assembly of Collegiate Schools of Business made exposure to the international aspects of the global business community mandatory in its accreditation standards. The student body at SIUE began to evolve with the construction of residence halls on campus. The faculty of the Department of Foreign Languages and Literature began to encourage its students to major or minor in a professional discipline, especially business, and to study outside the United States. The combined effect of these trends was to increase interest in internationalizing the business curriculum.

Developing an effective program to promote faculty and student exchanges is a key priority for institutions seeking to internationalize their campus environments. There are two fundamental approaches that a college or university may use when it wishes to establish international student and faculty exchange programs. The first is to create an umbrella or shell agreement that is normally negotiated between representatives of the chief executive officers of the respective institutions and signed by the chief executive officers. These agreements typically state that the campuses will assist in making the arrangements for students and faculty to study on the host institution’s campus on an as-needed basis. If, for example, a student at the parent institution would like to study at the host institution, the student would contact the International Programs Office at the parent institution (he or she might contact the host institution directly) to obtain the name of the appropriate persons at the host institution. Arrangements for the students to study at the host institution would be made between the student and representatives of the host institution. Colleges and universities taking this approach frequently have a large number of international exchange agreements, most of which are dormant for a number of years.

The second approach is for the institution to cultivate a limited number of exchange agreements that are based largely on the interpersonal interactions between the individuals who will be most directly involved with the creation and implementation of the agreements that while signed by the chief executive officers of the institution are administered within the colleges and departments that run the programs around which the agreements are signed. These agreements are generally focused on encouraging students to study in specific disciplines. The success of these agreements depends on the strength of the interpersonal relationships between the parties that administer the agreements on the respective campuses. The number of such agreements that can be sustained by a given campus during a specific time period is limited. The amount of activity undertaken under such agreements is likely to be much greater than the amount of activity present when international exchanges are characterized by umbrella agreements.

The Southern Illinois University system used both approaches. In developing its international exchange programs, the campus at Carbondale, Illinois, sought to negotiate and sign umbrella agreements. By the early 1990s, SIUC had such agreements with over 160 colleges and universities located outside the United States.

SIUE chose to use the second approach simply because the opportunity to create international student and faculty exchange programs arose as the result of personal contacts between faculty of SIUE and faculty of institutions seeking such agreements. In late 1987, a German Professor at the University of Hamburg established, with funding from private investors, a private School of Business to fill a void in the German educational system. At the time, there were virtually no federal, state, or privately supported higher education institutions that offered a curriculum similar to that of AACSB-accredited institutions in the US and Canada. In order to provide the opportunity for the baccalaureate and masters students in these programs to study overseas, the Professor contacted a colleague of his at SIUE to determine if an exchange agreement was possible.

At virtually the same time, the director of international programs at Sheffield Polytechnic University in Sheffield, England, while on a trip to the United States to complete negotiations on a agreement with Northern Arizona University contacted several SIUE to ask for a meeting to discuss the possibility of such an agreement with SIUE. Because the curricula at Sheffield were limited to Engineering and Business, the agreement would cover only business programs.

After meetings between the proponents of the German and Sheffield programs and the Dean of the School of Business at SIUE, exchange agreements were negotiated, signed, and implemented in 1988. Because Sheffield had agreements with similar campuses in Europe, contacts were then made by representatives from Haarlem Polytechnic in the Netherlands and Ecole Superieur des Sciences Commerciales d'Angers (ESSCA) in France. In each case, the contracts and agreements were negotiated directly between the directors of the international business programs at each of the foreign institutions and the Dean of the SIUE School of Business.

In July 1993, a team of faculty from the Toluca campus of the Monterrey Institute of Technology made a visit to several campuses in the Midwest seeking exchange agreements that would permit its students and faculty to study or teach in the US. One of those meetings was arranged by the Dean of the School of Engineering at SIUE, for the Toluca campus only offered degrees in business administration and engineering. As a result of an invitation issued by the Director General of ITESM-Toluca, the School of Business sent a contingent of five (the Dean, Associate Dean, Assistant Dean, who spoke fluent Spanish, an MIS Professor, and the Chair of the Management Department) to Toluca in January 1994. As the result of that visit, the two campuses signed an exchange agreement that was implemented in 1995.

All of these agreements were based on principles contained in the agreement originally negotiated with Sheffield-Hallam University in 1988. The agreement contained a number of key points that led to the success of SIUE's exchange agreements. The key points were as follows:

(1) Students pay tuition at the parent institution for the credit that they will earn as the result of enrollment or participation in the coursework in which they enroll at the host institution. This eliminates any issues that might arise as the result of the transfer of credit earned at one institution to meet the degree requirements of another institution. Using materials provided by the host institution, the student meets with his or her academic advisor at the parent institution to determine the courses in which the student will enroll at the host institution and how those courses will be used to meet his or her degree requirements. The appropriate staff of the host institution is then informed of the coursework in which the student is to be enrolled about his or her arrival at the host institution. The student can alter that schedule but only with the permission of his or her parent institution advisor so that the manner in which the change will be used to meet the parent degree requirements is determined in advance of the student's completing the coursework. The student's grades are determined by the instructors of the coursework taken at the host institution.

    If, as anticipated, the number of students from each institution is approximately the same, the extent to which one institution may be subsidizing the students of the other is small. In the case of SIUE, the president of the institution recognized that it might take a few years before the interest in study abroad programs would offset the anticipated inflow of students from our partners. He, however, believed that the benefits of the programs outweighed the relatively small loss in tuition that would result.

(2) All other fees and costs such as those for housing, other living expenses, books, and other course materials would be paid to the host institution. From this perspective, the exchange student was treated no differently than the native students of the host institution.
(3) The host institution would facilitate the enrollment of exchange students from the time that the student enrolled in coursework under the exchange program until the student had completed the coursework and returned home. To the extent possible, this has resulted in the treatment of exchange students as native students taking coursework at the host institution.

Because the Haarlem Polytechnic and ESSCA required that students enrolled in certain of their degree programs spend at least a semester studying abroad, SIUE received 10-12 students per year almost immediately. The flow of students from Sheffield was much smaller, typically one or two students per year. The agreement with the German International Business School began with two students seeking the SIUE MBA. This, however, grew to approximately 10 students per year before the agreement was terminated in 1994 with a reorganization of the IBS. By the mid-1990s, the SIUE School of Business was sending five to six students per year overseas. Another two to three students from other parts of the university also took advantage of the exchange agreements developed by the School to study overseas.

One of the concerns that had to be addressed was the reluctance on the part of SIUE students to consider study abroad programs. The typical SIUE student had done very little traveling. Travel outside the United States was viewed as too exotic, threatening, and literally foreign for them. Further, most students worked to provide the funds used to defray part, if not all, of their educational expenses. Few felt that they could afford to study abroad for a semester or longer. Students were more amenable, however, to the idea of organized short-term study abroad trips that included other students as well as faculty.[3]

In discussions with the faculty and staff of ITESM-Toluca in 1994 and early 1995, SIUE developed a two-week, total emersion program for its students in Central Mexico. The program was constructed as follows:

(1) For approximately half of the day during the week, usually in the mornings, the students would participate in seminars on Mexican culture, history, business practices, law, and economy taught in English by the faculty of ITESM.
(2) In the afternoon, the students would tour various Mexican businesses ranging from small shoe factories to the Mexican operations of multinational firms such as Daimler Chrysler, BMW, and Coca Cola.
(3) On the evenings and weekends, the students would meet with their counterparts from the Toluca campus to experience life as a university student in Mexico as well as see some of the central Mexico, including communities such as Taxco and Villa de Bravo.
(4) ITESM provided the housing for the students while SIUE paid for the other expenses associated with the program.

The program was originally funded by a $12,000 grant from the SIUE Excellence in Undergraduate Education program to send up to eight students and two faculty to the campus of ITESM-Toluca for two weeks in summer 1995. The funds from this program are used to encourage educational innovations or to permit the faculty to experiment with ideas before seeking university approval for curriculum or program changes. Using these funds, the School could pay for the participant's airfare, lodging, and other expenses except about one half of the student's meals and entertainment. The out-of-pocket costs to the students were typically $400.00 for the two-week period. The financial support for the program, its two-week intensive format between the summer and fall terms, and SIUE faculty participation dealt effectively with the major impediments to participation in exchange programs: cost, disruption of jobs, and concern over travel, especially outside the US. By April 1st, the School had received 15 applications for its 8 student positions. Of the eight students selected, one had to withdraw for personal reasons shortly before the group left for Mexico.[4]

Students had to apply to participate and be prepared to write papers on their anticipated experiences prior to going on the trip. This was followed by a paper discussing the effects of their actual experiences on these perceptions. Completion of the requirements and enrollment in the program permitted the student to earn 3.0 semester hours of credit. The applications were screened by a group of faculty. The program was originally designed to accommodate up to 8 students. By 2000, the program had been expanded to accommodate 15 students.

The success of the Mexican Study Abroad program led to the creation of other two-week programs in England (Sheffield and London during Spring Break), China (May), and Germany (Leipzig and Hannover during Spring Break) and a three-week program for MBA students in France (May of each year). These programs have also led to two to three week community service programs in Costa Rica and Mexico. While some students pay all of their costs of participation, the School still provides scholarships that defray most of the expenses of these trips. The funds for these trips have been raised from contributions to the School by donors interested in supporting international exchange programs and the proceeds from its annual Golf Outing.

As a result, since 2000, annually approximately 50 SIUE School of Business and another 20-25 other students spend between two and three weeks in total emersion programs. The School of Business annual receives 25-30 students from its partner institutions that study at SIUE for one to two semesters. The School also receives 10 to 30 students from ITESM-Toluca who take courses during a five-week summer session.[5] The summer session curricula were adjusted in 1998 to maximize the contact between SIUE and ITESM students. Activities were arranged so that the ITESM students had contact with SIUE students outside of class as well.

In addition to the students participating in the short exchange programs, approximately five to six SIUE students now spend one or two semesters studying abroad. Most of these students study either in England or in the Netherlands where coursework is offered in English. One or two students will study in France, Mexico, or Spain where coursework is taught primarily in French or Spanish.[6] Effective with classes offered in fall 2004, participation in one of the School's international exchange programs will be required of all students wishing to specialize in International Business in the BSBA program. Students must earn at least 3.0 credits through a foreign exchange program to complete the baccalaureate with this formal specialization.

In order to create an institutional culture that provides adequate depth and breadth to the discussion of the international aspects of business education, the School also realized that it would have to encourage faculty participation in programs that broadened their understanding of the international environment. In addition to sending faculty to attend various seminars sponsored by the AACSB and the federally funded Centers for International Business Education and Research (CIBER)[7], the School of Business sought to establish faculty exchange opportunities with its partners. One of these arrangements has proved to be successful. The other programs that were devised have been less so.

The School originally wanted to develop a program with its partners in which at least one of its faculty members would teach at a partner institution for a semester while a faculty member from that institution would teach at SIUE. The faculty members and their families would exchange houses, transportation, and other forms of support for the period. In the original plan, each faculty member would remain formally on the payroll of his or her parent institution to avoid the issues of contracts and salaries. In the Spring 1995, two faculty from SIUE went to France, one to teach at ESSCA while the other taught at Universite Catholique de l'Ouest, while a husband-wife from ESSCA and Catholique, accompanied by their two children, taught at SIUE in the School of Business and the Foreign Language Department. While this exchange was quite successful and led to two SIUE students studying in France simultaneously, the logistics have proved too difficult to achieve the objective of having at a one for one faculty exchange each year. Although there have been several attempts to arrange subsequent exchanges, all have failed primarily for three reasons: (a) The differences in academic calendars, (b) Finding a faculty match that does not leave one institution with the problem of finding a replacement for a faculty member who teaches upper division and graduate level courses, and (c) Personal reasons involving relocating family members that could not be resolved..

A second approach to providing the opportunity for faculty to acquire some international experience has been more successful. ESSCA, prior to signing its agreement with SIUE, had been experimenting with an approach in which it invited faculty and other experts to the campus in the week prior to Christmas to deliver essentially a short course on a topic to be defined and agreed upon by the institution and the faculty member. The course would meet for three to five days and afford the student the opportunity to earn additional academic credit while permitting ESSCA to bring expertise to the campus that it would not normally be able to do for the typical semester or academic year.

The opportunity to spend a week to two weeks in France proved to be quite attractive to SIUE faculty. This led to the development of a program in which a faculty member from SIUE goes to France in late fall to teach a seminar on a topic that is agreed upon by ESSCA and the faculty member. A faculty member from ESSCA comes to the SIUE campus in the Spring Semester to deliver a series of lectures on related to topics to several classes offered on the SIUE campus. The parent campus pays the airfare of the faculty member while the host campus pays all other expenses associated with the program.

The program has led to similar exchanges although periodic exchanges with faculty involving our partners in the Netherlands, the United Kingdom, and Germany. This exchange led to two other types of experiences. Haarlem Polytechnic, using funds from a donor created an International Education Week in which it invited faculty from five to seven international partners to make presentations to faculty and students on themes related to international business. The following year, SIUE hosted a similar international education week. A second two-year cycle of this program was completed in 1998-9 and 1999-2000.

Contacts made during these sessions, the ESSCA exchanges, and the Mexican summer study tour led to another type of exchange. Using a grant from the US Department of Education, faculty at Sheffield and ITESM-Toluca partnered with SIUE faculty in a program in which the students enrolled in similar classes at SIUE and the partner institution would essentially be integrated into a common course. Depending upon the level of the students and the nature of the course, the students were formed into teams. On some occasions the teams were composed of home institution students who essentially competed with students from the other institution in addressing certain assignments. On other occasions, the teams were composed of students from both campuses. At least once during the course, the students met in a video conference to present their results. On one occasion, the teleconference took place between students in the United Kingdom and those in the US.

These courses forced the students to deal with cultural issues, time differentials, different decision-making styles, and differences in communication. The students used a variety of internet-based services to communicate with one another or to present ideas that were being discussed in the class sessions held on each campus. The students also learned how to cope with the problems created by technologies that are innovative, for the best laid plans for videoconferences can be altered by circumstances such as sunspots that occur without much warning and over which the student has no control. Students were not the only beneficiaries of the program. The close collaboration required of the teaching faculty members enhanced their own cross-cultural skills.

A final activity was designed to increase the number of faculty participating in student study-abroad trips. In addition to the five faculty members that were involved in the organizing and teaching of the study abroad trips, 12 additional faculty members participated in the programs that led to study in China, France, Mexico, and the UK. Faculty with little international experience who were teaching courses that could be enhanced by adding an international dimension received funding to participate in the program. They received the same benefits that the students received from their total immersion in that the experiences were then incorporated into their teaching. Faculty and students developed friendships on the host institution campuses that led to the hosting of students and faculty from those institutions when they came to SIUE.

By the academic year 2001, the SIUE School of Business had developed a series of exchange programs that:

(1) Provided up to 50 students per year the opportunity to study overseas for a period of two to three weeks at very little cost to them,
(2) Provided those students who wished to study abroad for a semester or a year the opportunity to do so at five institutions in Europe, one in Mexico, and two institutions in China as though they were enrolled for credit on the SIUE campus using their standard financial aid packages.
(3) Brought 25 to 30 students enrolled at partner institutions to study at SIUE for one to two semesters. These students enrolled in three to five third and fourth year courses. This means that virtually every SIUE junior and senior is enrolled in a least one course in which an exchange student is enrolled.
(4) Brought 10 to 30 Mexican undergraduate students to study for five weeks during the summer. During this stay the students would meet with the SIUE students who would be going to Mexico for two weeks in August.
(5) Provided at least one SIUE faculty member the opportunity to teach overseas for one to two weeks while bringing at least one faculty member to the SIUE campus to teach and participate in coursework for a period of a week.

(6) Provided students enrolled in a senior level International Management course with the opportunity to work for one semester with students enrolled in a similar course on the campus of a college or university outside the United States. Students in the MBA program and other senior level courses had periodic opportunities to participate in this format as well.
(7) Provided three to five faculty per year with the opportunity to spend two to three weeks studying the business culture and institutions of at least one other country.
(8) Attracted the attention of donors and other School constituencies.

By the beginning of the 21st Century, the School of Business had made significant strides towards creating a culture in which the international aspects of the business environment were integrated into the design and implementation of its curricula and degree requirements. Approximately one third of the faculty had participated in some form of exchange. Student participation in exchange programs had increased 30 fold, and hundreds of other SIUE students met foreign-born students or native-born students who had studied abroad in their classes and other campus activities. By fall 2003, approximately 3.8 percent of the students enrolled at SIUE were international students, a figure that compares favorably to the national average of 4.3 percent.[8] The Curriculum Committee of the School had accepted a faculty recommendation that students seeking the International Business Specialization had to have some international experience and at least 2.5 years of a college-level foreign language coursework. New faculty were recruited with the understanding that they were at least encouraged to acquire some international experience prior to being granted tenure and promotion. A perceptible number of students had some international experience and each junior and senior student took at least one course in which an exchange student was enrolled.

IV. Conclusions

During the decade of the 1990s, SIUE developed a reasonably comprehensive, mutually reinforcing set of exchange programs that led increased in a substantive way the diversity of its student body and faculty. The experience led to the following conclusions about the development of international exchange programs and the roles that they may play on the campuses of regional and metropolitan colleges and universities:

International exchange programs must be tailored to fit the mission, goals, and character of the college or university. A program that works very well at a private institution or a large research oriented university is not likely to work as effectively at a regional or metropolitan, publicly supported university. The attempt by SIUE School of Business to develop a faculty exchange program in which at least one of its faculty would teach overseas for a semester in exchange for a professor from one of its partner annually failed primarily because the faculties of the School and its partners were not sufficiently large to find an appropriate match. Such a program is much better suited to a college or university in which the faculties are very large. Furthermore, the short-term study abroad trips were designed to fits the needs of a relatively parochial, lower-income student body. Student issues related to study abroad in private and/or more cosmopolitan universities may be quite different. The international exchange program must play a well-defined role in assisting the college or university in addressing its mission and goals. The program must be a part of the culture of the institution if it is to be more than simply a part of the "things" that a college or university offers because colleges and universities are expected to offer such opportunities. If the university culture does not believe that international exchange programs are part of its core activities, the programs will never develop to become more than secondary or tangential parts of the university. In the 21st Century, a campus can never really claim to have a diverse student body or faculty if it does not have a healthy international exchange program that insures that its student population is exposed to international students and that its students have realistic opportunities, that is, opportunities that are affordable and available in some depth and breadth, to study abroad.

International exchange programs are like friendships, if fact, most effective international exchange programs are based upon the friendships that develop as a result of the agreements. Effective exchange agreements at most regional colleges and universities require that they be administered by a person who is committed to the programs. The program's principals must consider their participation in the programs to be more than simply a job or part of their jobs. The key personnel must believe that exchange programs are a core activity of the department, school or college, and university.

Exchange programs require a lot of work and the commitment of sufficient resources to make the programs function effectively. In that sense, effective international exchange programs are like good friendships. Both require commitment on the part of both parties to do those things that are necessary to maintain and strengthen the bonds between the parties. Effective exchange programs, for example, require that key personnel visit the partner institutions at least once per year. Such visits serve several purposes. The parties are introduced or reintroduced to key administrators so that those persons are reminded that the programs are active and the partner remains committed to them. Key personnel are able to meet with prospective exchange students and staff to answer their questions directly. Difficult issues are easier to discuss and resolve in face-to-face conversations than over distance and several time zones. Effective exchange agreements require that the parties know and trust one another. The formal language of an agreement does little to insure its success if there is no one on each side of the agreement that is committed to making the program work. Problems are resolved efficiently when a party at one institution feels comfortable simply picking up the phone or sending an urgent e-mail knowing that the person at the other partner institution will work to resolve the problem in a timely manner because he or she has a personal commitment to, not only the program, but to the friend who has made the request. International exchange programs are, in fact, an illustration of one of the key points made in every international management class. In international business, formal contracts mean far less to successful business dealings than friendships. Friends trust one another, that is, each must be confident that the partner would not knowingly mistreat the other. Strong international exchange programs are based on mutual trust and friendship. Without these key ingredients, most international exchange programs will fail. Like some friendships, some exchange agreements are not meant to last forever. Just as friends part ways, institutions may end exchange agreements because the goals and objectives of the parties for such programs have diverged. This happened to the agreement that SIUE had with the IBS in Germany. When the board of the IBS decided to change Chief Executive Officers and to alter its mission, the exchange program with SIUE no longer seemed appropriate and was terminated by mutual agreement. When a key person leaves an institution, it may be difficult to form a subsequent friendship that will retain the mutual trust required for the program to remain viable.

The mutual respect and trust engendered by friendship also leads to the experimentation and innovation that permits exchange programs to add value to the educational programs of the institution. Such friendships can lead to scholarship that benefits both parties and institutions. The resources available to faculty increase in ways that are not always obvious. In the end, the friendships lead to greater depth and breadth to the number of students and faculty who take advantage of the opportunities afforded by the programs.

International exchange programs must become a part of the culture of the unit, school, and university, that is, effective programs must be able to transcend changes in personnel and the commitment to the programs must be transmitted from one generation of faculty and staff to the next. New employees must know and become convinced that knowledge of and participation as appropriate to the position in exchange programs is expected. It is not unreasonable, even at a regional or metropolitan university, to require that a probationary faculty member acquire some international experience in order to be granted promotion and tenure. The institution must provide the opportunities to meet this criterion but the requirement is not unreasonable, especially if the faculty member teaches courses within an international business program or with international content.

Even if the diversity of the faculty, staff, and students on a university community were not the central focus of recent Supreme Court cases, one would be hard pressed to argue that, at least in certain disciplines such as those of business and social sciences, exposure to international perspectives and practices is essential to the education of students majoring in one or more of those disciplines. It is hard to argue that a business student with only minimal understanding of the international business environment is prepared for a business-related career in the 21st Century.

Yet, one still hears arguments from politicians, average citizens, and others that the resources of a publicly-supported college or university should not be "wasted" on international exchange programs. The taxpayers' funds should go only to educate the children of and citizens of the state. The illogic and irrationality of such arguments need not be discussed further. The fact that they persist is a comment on the nature of politics and the quality of the educational background of the average citizen more than it is a comment on philosophical rationale for taxpayer-supported post-secondary education. Unfortunately, however, because such views persist and higher education is a convenient target for the politician who wishes to divert attention from other problems and issues, the role of international exchange programs will come under periodic scrutiny and be the subject of comment and criticism.

This provides the rationale for creating and implementing international exchange programs that are clearly related to the mission and goals of the institution and that such programs become part of the culture of the institution.

References

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[2] Grutter v. Bollinger. United States Supreme Court 02-0516.

[3] Jaffe, G. (October 6, 2003). "Army Finds Good Information in Short Supply in Guerrilla War," The Wall Street Journal, page A-1.

[4] Kwok, C.Y., Arpan J., & Folks, Jr., W.R. (1994) . "A Global Survey of International Education in the 1990s," Journal of International Business Studies, 25(3), 605-23.

[5] Margulies, J (September 6, 2002). "American's Support for an International Thrust in Academe Remains Strong," Chronicle of Higher Education.

[6] Regents of the University of California v. Bakke. 438 U. S. 265 (1978).

End Notes

[1] The basis for this argument is found in the opinion that Justice Powell wrote in the *Bakke* case. In developing its criteria for admissions to its Law School, the University of Michigan had argued that ethnic origin (race) served a compelling interest in creating the diverse student body desired by the Board of Regents of the University of Michigan. In writing for the majority, Justice O'Connor argued that the *Bakke* case established a "binding precedent" that justified the use of racial preference in granting admission to various programs offered by the university. The Court also rejected the equating of a "critical mass" of students with certain qualifications to a quota. See *Bakke* and *Grutter*.

[2] See Justice Powell's opinion in the *Bakke* case for the origins of this argument.

[3] When the exchange agreements were first signed, students on financial aid were told that they could not use their financial aid to pay for study abroad programs. This interpretation turned out to be inaccurate, especially when it was noted that the students paid tuition to SIUE for the credit earned as the result of their participation in such programs. Reinterpretation of the rules governing other types of grants now permit students to use those funds to pay for expenses incurred while studying abroad.

[4] The first group consisted of two men and five women of which three of the women were African-American. One of the male students spoke fluent Spanish. The program has always tended to attract more women than men with approximately 70 percent of the participants being women.

[5] The Mexican students who study at SIUE in the summer are the direct result of the two-week August program that sends SIUE students to ITESM-Toluca. The costs of the two programs are such that bilateral participation essentially offsets the costs incurred by each program. There is very little transfer of funds between the campuses as the result of the bilateral nature of the program eliminating concerns about international transfers of funds and exchange rate fluctuations.

[6] SIUE has no formal Exchange agreement with a Spanish university. Students who wish to study in Spain make arrangements to do so through the Spanish faculty of the Department of Foreign Language and Literature. The students enrolled in these programs do have to deal with the transfer credit problem as well as other problems that can arise when there is no formal agreement in place.

[7] Southern Illinois University Carbondale and the University of Memphis were awarded one of the original CIBER centers. This co-sponsorship proved to be difficult to manage resulting in the movement of this Center to the campus of the University of Memphis.

[8] College Board Annual Survey for 2002/3. Figures are based on enrollments in fall 2001.

Using a Course Management System
to Enhance Traditional Teaching of Business Courses

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Abstract

This paper shows the use of a CMS to augment a traditionally taught course. It explains the process used to develop case problems in business courses with student involvement through discussion in groups on-line. Some relevant features in Blackboard, a specific CMS, that could be used to make the case problem easier to access and solve is explained.

The question arises: Are challenges more easily met by traditional classroom management techniques or by more automated course management systems? The focus of the paper is to show the value of hybrid courses to maximize quality classroom time. Documents for peripheral activities are prepared and stored in Blackboard. Such activities include case production and distribution, creating groups, creating relevant external links, posting announcements and setting benchmarks. The emphasis is on the value of the approach using both technology and face-to-face interaction as contrasted with the amount of effort expended to implement it.

Background

This paper focuses on two methods, the case method and follow-up discussion, as examples of some commonly used techniques that instructors use in the classroom in order to teach, review, assess, or reinforce concepts in business classes. A description of case development is followed by factors to be considered in using the discussion method. The paper then explains how to enhance, supplement, or replace these traditional methods by using a course management system (CMS). Blackboard is the CMS chosen for this paper as it is representative of the systems currently available to both educational institutions and to businesses.

Both technical and non-technical classes can benefit by using a CMS. The model class for this paper is a technical course in Computer Applications in Business, one that is taught traditionally with lecture, demonstration, and application usually conducted in a self-contained classroom or lab environment. Outside work includes case problems, Internet research, data collection, and original integrated projects. Some in-class activities along with hands-on application of software include small-group collaboration, case problem discussion, peer-to-peer assistance, and oral presentations. This paper uses the Computer Applications class as a hybrid class, employing face-to-face interaction in a three-hour weekly class as well as being augmented with Blackboard course management system.

The aim of this paper is to show how a traditionally taught class was energized by using the features of Blackboard CMS to support the case method and discussion. It describes the components of these methods and then show how these are supplemented, enhanced, or replaced by the CMS. The underlying premise of the paper is that most instructors are acutely aware of the importance of the quality of the time spent in the classroom. Therefore, having an auxiliary technological aid such as a course management system could be of great benefit for instruction as well as using peripheral activities. These include such typical classroom housekeeping chores such as announcements, explaining assignments, distributing handouts, copying documents, and document storage.

Case Method Background

The terms case method and case study are sometimes used interchangeably. Case study or case report means the in-depth analysis of a problem, with no necessary implications for practice. The case method in contrast, as developed by Langdell of Harvard's Law School in the 1880s, refers to the method of instruction based on real-life examples. There is no field of study that cannot benefit from this broader definition of the case method.

Using case method as an umbrella encompasses looking at all aspects of actual living experiences, whereas case study allows the analysis of either real or contrived situations: There are benefits to the educational process using both techniques. Instructors do much time-consuming research to find corporate examples, with all the jumble of factors that go into any real-life situations. It takes numerous hours to center the focus on important aspects so that student-analyzers can use their time and talents most effectively. It is vital to frame the structure of the actual experience so that students do not get bogged down in extraneous details or digress into relatively minor areas.

In case studies the instructor can use more latitude when constructing the situation. One case may contain elements of many real-life situations or of fictional problems experienced by any typical business. Studies can be shaped to include situations particular to small companies so that students can appreciate the complexity of that type of business. Working with larger companies or with very large departments within a corporation may show a broad variety of situations. Constructing composite cases allows the instructor to take certain liberties with typical situations. Whereas an actual company's experience must be reported as it happened, the fictional or composite case can add to or strip away facts.

Using the broader definition of case method allows for its use in a variety of business courses, technical as well as non-technical. The course in computer applications used in this presentation employs numerous cases directly related to solving specific short- or long-term problems in business. Since the emphasis is on using software as a tool to making decisions, each case focuses on the situation related to various software features. For example, a case may be constructed to employ whatever features are being studied. In database study, for example, fields from various tables may be needed for a query of the file. So the students must recognize how to set up relationships and then to use interrelated tables as needed.

Components of Case work

There are three parts of case study: the case description, the analysis of the problem or situation, and the follow up with a report and/or discussion.

Case Description

The instructor may choose to use cases from a variety of sources or may create original ones. Traditional college textbooks provide constructed cases to fit the content of active chapters. Third-party sources such as Harvard Business Review publish topical cases for use in various fields of business: management, information technology, marketing, or advertising, for example. Professional teams can design cases which can take years to prepare. Pigors and Pigors [6] note that the Harvard case studies, although well known for their extensiveness and excellent quality of research, may be too detailed and time-consuming depending on the academic level in which they are used.

Many conventional sources for constructing shorter case studies are available in the day-to-day activities of any institution. The imaginative mind could construct viable business cases from minutes of meetings, policy documents, or institutional reports. Because these cases are constructed for the student learner or reader, the instructor should be careful to match the experience level of the case to the reader. Unfamiliar terms or concepts should be either avoided or explained. However, some challenges should be worked into the case in order to stretch the student readers' imagination and critical thinking.

In constructing case problems the format is most important. It should focus on problems which have complexity and which can elicit a variety of views from the readers. Other than describing a real or imagined business problem to use with students who may have limited knowledge of the business world, there is another purpose for using the case method. This goal is to help to hone analytical skills to name the problems, identify alternative solutions, and discern the possible consequences of various solutions.

The degree of complexity is what separates the full case method and report from simpler problem-solving exercises. In shorter less complex cases the problem may be immediately identified, and the steps to solve the case may be listed. Instructors have a choice of cases depending on the context of the problem within their course topic.

According to Marsick [4] the case problem must match the interests of the readers and should be relevant to their experience level. Facts about the problem should accompany the environmental context: a description of the broader organization's work or products, its clients, or special conditions which may be relevant to understanding the problem. Adding realistic details helps to put the reader into the situation itself. Using visual images through videos or references to films or television also helps to put the reader within the problem.

For example, when dealing with cases using databases that involves an inventory of an electronics store, it helps to have students imagine standing in the local electronics retail store. Students can offer specific names of local stores and their layouts. From that vantage they then can hone in on one particular device—cell phones, DVD players, PDAs or any other device of particular interest to them. It is not unusual for students to relate to this scenario since many of them work as clerks or managers in stores of this type.

Information included in the case can be tailored to fit a specific solution or encompass several paths. Several groups may then work on the case and arrive at different views or solutions.

If the instructor so chooses, the report may be followed up with a description of the actual solution of the problem. This could be used to compare or to contrast with the results the student readers have devised.

Case Analysis

Student analysis of cases in computer applications entails searching for pertinent facts within the complex problem or situation and then discerning which features of the software to use to find a solution. As the complexity of cases increase, so do the possibilities of solutions. Helping students to focus means directing them to keep to the relevant facts and avoid excessive digression or speculation.

Case analysis can be aided by leading questions or notes that help readers in order to determine specific solutions. In other cases they could suggest solutions that the readers have to analyze the process used to justify how these various solutions may have been reached. All case problems do not have to be self-contained. Some cases can be used as springboards to encourage or demand further research either off- or on-line. Research on an inventory problem in a database course can include identification of a certain product suggested by the case.

For example, in the case of the electronics store inventory stated above, students could choose one specific device that they are particularly interested in. From that could flow the examination of a similar real-life product. A selection of cell phones could be researched, naming popular brands and accessing those brands on the Internet. Database fields constructed may include size, power, internal specifications, external peripherals, and price. Having several students exploring various products within the same general department of the electronics store can result not only in categorizing the inventory but also allocating space needed for the products.

The goal of case analysis is to sharpen students' analytical skills as well as to project them vicariously into a professional setting. Students could take on the character roles suggested in the case. Since case complexity causes divergent thought about what may be the "right" solution, students may also learn that making decisions in realistic business situations is not so simple. It may show them that others have strong arguments to justify their solutions and that negotiation skills learned are as important as arriving at the "right" answer. They may also discover that there is no such solution as the "right" one.

Case Discussion

Another component of the case method is the discussion. If the case is sufficiently complex, the analysis and suggested solutions may go far beyond one or two answers. There are several ways to work with discussion following the case analysis: one-on-one with the instructor, small or large group work with two-to-five students, or full-class participation. Each of these has benefits and drawbacks.

One-on-one Discussion

Depending on time constraints the individual interaction of the instructor and the student could yield many benefits. Some students have never had a direct conversation in which their answers are used as springboards for the next comments or questions. Some have never interacted that closely with a professor. Although this could be intimidating, it could also stimulate quiet students to express themselves in a closed environment of an office, away from judgmental or more vociferous class members.

The instructor may also use the Socratic method, drawing answers by direct questioning and then building on them. Another approach would be for the student to begin the case analysis and respond to questions from the instructor during the presentation for further clarification. A third approach would be for the student to present the full analysis and then discuss concepts or variations on the solution.

Groups of Two-to-Five Students

This can be carried out during or before a class session. The mode in which the small group meets can be face-to-face, through e-mail, or through the CMS which will be described at length later in this paper. If the analysis stage includes specific questions to lead the discussion, each participant should have answers or points to consider ready prior to the discussion. Otherwise, the participants are left with an open-ended approach to the discussion.

Inexperienced students who do not have opportunities for group discussions may benefit from more experienced students. The groups must decide on their mode of discussion and their various roles—as leader, as questioner, as devil's advocate, as negotiator, as summarizer, and as recorder. If the group is too small for these roles to be distinct, the instructor can point out that the functions of these roles can be combined. Thus small group discussion includes both an examination of and exposure to the process of sharing in a group as well as the actual steps needed for each student to present the analysis for discussion by the group.

Full-class Discussion

This mode can be used either alone or as a consequence of the small-group discussions. Large group discussions expose students to a variety of perspectives. They can reflect on their own conclusions found in another student's statements. Students are often able to reaffirm their own analysis or conclusions after sharing these with others.

The overarching purpose of discussion, according to Brookfield [2], is to help learners to explore their experiences or conclusions so that they become more critical thinkers. This method helps them to become aware of nuances in cases they are working on. It shows them the value of being flexible and open-minded, accepting other's statements or else honing their debating skills. If two groups differ in their conclusions after working on the same case, the in-class discussion gives them a chance to clarify their processes.

Although Legge [3] proposes that "discussion is most appropriate to those subjects concerned with controversial issues about which there are different but equally tenable opinions" (p. 78), there is room for other topics for discussion. For example, there are cases in Computer Applications which indeed have correct answers as in mathematics. There may be numerous ways to arrive at these definite answers, however. So discussion of these processes is valuable in that there may be more efficient paths to the conclusion. If there is only one way to arrive at the conclusion and there is only one right answer, as in many business cases involving software, then the students still can learn from one another.

Preparation

The instructor should prepare the students for the group discussion experience and not just presume that this activity comes naturally within an academic environment. Skills are needed to keep the discussion focused, to be sure all students are involved meaningfully, and to be sure that all components of the case are handled.

Prior instruction to prepare students for discussion include notifying them of specific questions which must be answered first by individuals, then by assimilation into one group answer. Students may decide to offer majority/minority views in the event there is division on several acceptable answers. Other preparation involves meeting their group's members, either face-to-face or on-line as well as knowing what criteria will be used to assess their participation in the discussion. The CMS system is helpful here in that one document containing rubrics can be kept on the site for frequent reference.

Criteria for Analysis of Discussion

A specific set of rubrics should be given to the class. Self-analysis should be the first order of business. Let each student read the criteria for grades from the rubric list and then assign an objective grade to him/herself. Those students who take the experience seriously may use this rating as a wake-up call. Others will at least realize that there will be an accounting for their contributions or lack thereof in the discussions. An example of a discussion rubric for business case problems follows in Fig. 1. Other suggestions for creation of rubrics can be found at: http://school.discovery.com/schrockguide.

A or A-	Completed case problem prior to entering discussion Read and understood reading material peripheral to the case Discussed case fully with group members Was self-motivated to study and solve case Took initiative in discussion topic Shared and discussed external material relevant to the case Responded readily to discussion in class or in Blackboard Participated in discussion with insight and enthusiasm Offered help and support to other group members Visited site and participated daily
B+ or B	Partially completed case problem prior to entering discussion Became familiar with reading material peripheral to the case Discussed case intermittently with group members Needed grade or deadline motivation to study and solve case Participated in discussion when others presented ideas Researched external material relevant to the case Helped others in the group when requested Visited site and participated frequently
C+ or C	Read and completed some of the case problem prior to entering discussion Skimmed reading material if it was required Discussed case at times with group members Motivated by immediacy of deadline Listened to others rather than offering solutions to case Clarified answers or comments of others but gave no original insight Did no research for external material relevant to the case Occasionally visited site and participated sporadically
F	Rarely or never visited site for case discussion Neglected to participate in discussions in class or in Blackboard Did not read or complete the case Was not a significant presence in the solution of the case Gave no support to other members of the group

FIG 1. DISCUSSION RUBRIC FOR BUSINESS CASE PROBLEMS

Members of the group will rate themselves and others using the same criteria. This should give an incentive to students, as they realize that their contribution allows the discussion to move forward meaningfully. In the event that students are reluctant to rate others, the instructor can make the process more neutral while still maintaining some degree of student rating responsibility. For example, instead of the conventional "A", "B", etc. or "1", "2", etc. rating systems, the students might give qualitative word ratings such as "Extremely Helpful", "Very Good Contributor", "OK", "Sometimes Helpful", "Rarely Helpful", "No Comment".

Other ideas for rating members of the group's participation and contribution may include evaluating each student with a numeric rating, such as 1=Most Helpful, 2=Next, etc. The instructor will use the rubric to assign grades in conjunction with the group input.

When conducted correctly, discussion is not especially easy. Students should be alerted that their opinions and thought processes will be exposed to others in their group with the opportunity for disagreement or dissention. They must attend to the opinions and thought processes of each of the other members of the group. Discussion places the responsibility for the success of the activity in their hands. Contributions are expected from each member of the group with the concomitant possibility of trying to interpret confusing or poorly stated thoughts. Participants can learn how to work with a variety of personalities and levels of awareness. It is valuable for students to listen to and compromise with others in the group, trying to come to some agreed-upon answers from those who may have more insight or who may understand the problem more clearly than others.

Working collaboratively is one of the goals most business classes try to incorporate in anticipation of the experiences students will have when employed in the business world. It is hoped that shorter but more frequent experiences the students have in the classroom will prepare them for the challenges they will have when employed.

Using the Course Management System to Augment Case Analysis and Discussion

Now that the cases have been developed and the students have been prepared for the discussion method, there are many features in Blackboard and other CMSs which allow for efficient delivery and interaction. Using these many powerful features allows time spent in the classroom to be more content-oriented as some of the traditional housekeeping chores can be shunted off to the system.

Preparation time can be spent on designing auxiliary slides, arranging quality handouts, designing review quizzes, and creating meaningful assignments, all of which can be uploaded to the CMS. These can be made available to the students at the appropriate times.

Production and Distribution

One problem faced by instructors in traditional classes is the production and distribution of the cases. Handouts in a classroom with the case printed for each student is the usual distribution method. Inevitably some students do not receive the case either due to being absent or having lost the paper. Instructors may find themselves bogged down with carrying all their files to each class to accommodate these students. The amount of paperwork necessary for developing and distributing cases is sizable.

There are features in Blackboard CMS which speed up the process of both case construction and distribution of cases to the students. Case construction is aided by using Course Packs available from textbook vendors. These packages are available from the vendor after the texts have been adopted by the institution. The course pack is downloaded to the CMS administrator who in turn exports it to the designated courses. Most course packs assume total coverage of certain CMS features, so the instructor should be aware that additional items may have to be restored or created in these affected features.

The following section describes some of the features most commonly used to conduct a class in Computer Applications as a hybrid course. Using both face-to-face instruction and interaction with Blackboard resources allow for greater quality time in the weekly classroom meetings. Fig. 2 shows the selections available to the student in Blackboard.

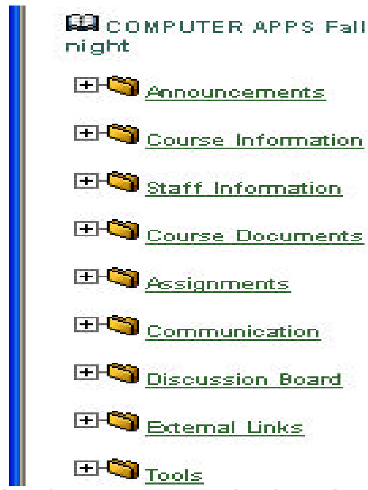

FIG 2. STUDENT BUTTON SELECTIONS

Announcement—alerts student that there has been a change in the site. Add an item to state that there is a new case as of a certain date. Direct the student to choose the appropriate button to access the case and get directions.

Course Information—stores the course outline for frequent reference for structure of course, goals, texts, and grading criteria.

Course Documents—store the case by browsing from the source computer where the instructor has composed the case as shown in Fig. 3. Give noted instructions for the student to download in the event the case is a packaged file that needs to be unzipped. The document containing the rubric for evaluation discussions can be uploaded and stored in this section.

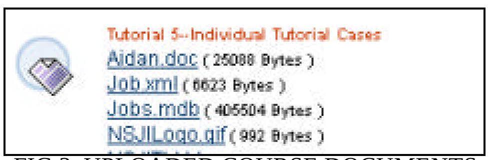

FIG 3. UPLOADED COURSE DOCUMENTS

Staff Information—shows instructor and student assistants, through imported photos and hyperlinks, contact information, office hours, or lab times.

Assignments—examples of specific directions as shown in Fig. 4. Instructor states details of assignments for those who missed class or need further explanation. Documents needed for the discussion phase of the process could be uploaded to this section.

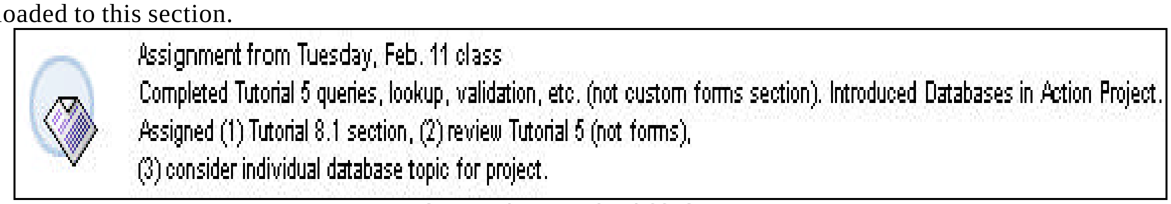

FIG. 4 EXAMPLE OF ASSIGNMENT

Communication—shows a variety of communication features as shown in Fig. 5. Many of them hyperlink to other resources.

FIG 5. COMMUNICATION FEATURES

Discussion Boards—show how new forums are created and the process used for threading discussions. Practice this feature in the classroom with small groups and questions that require at least 6-8 interactions on one topic. Practice while the students are interfacing in the classroom so that they know how to begin new topics related to the questions.

Group Pages—show the members of the groups set up by the instructor as shown in Fig. 6, privileges granted, and e-mail addresses for each member.

FIG 6. STUDENT GROUPS AND PRIVILEGES

Digital Drop-box—allows students to upload and send a file to the instructor only. Instructor examines document and sends it back via the same procedure.

Calendar—keeps a record of the day the case was posted as well as the due date or any benchmarks for noting the progress of the case as shown in Fig. 7.

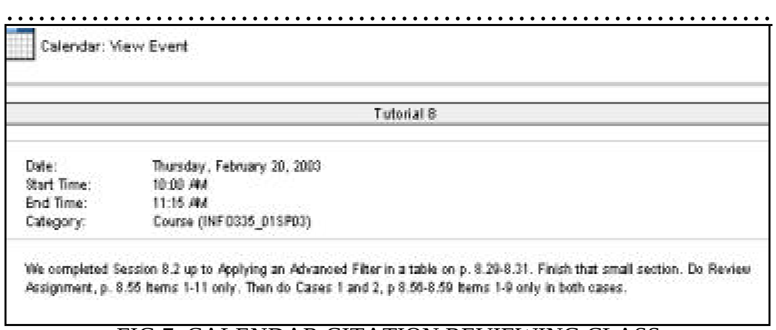

FIG 7. CALENDAR CITATION REVIEWING CLASS

Assessments (quizzes and tests)—allows both objective and subjective questions. Instructor should direct students to be specific in their answers. For example, cite if it is preferable to type dollar signs or if numbers should be rounded off.

Gradebook—shows results of the automatic grading of the assessment. Instructor can make manual adjustments.

External Links—connect to any Web site, for example, as shown in Fig. 8, for additional data, graphics, or reinforcement.

FIG. 8 SAMPLES OF EXTERNAL LINKS

Video clips—show expository or motivational clips. Some suggested sources are interviews with corporate mentors, segments from television business shows (with permission), views of a variety of corporate and business settings, or visits to database supervisors.

Summary

Learning, especially in the university, requires many things to go right if creativity and knowledge are to be fostered in students. Antecedent conditions to the learning process must be addressed, including learning styles of students, multi-modality of the instructional media, and preparation of the instructor and instructional materials. Similarly, transactions that seem to lead to learning include ready access to instructional materials, student time-on-task, sequencing, and constructive feedback. Aligning even some of these factors for a successful outcome is challenging to most educators.

In order to mesh effective teaching with technology to achieve efficient, effective instruction, this paper illustrates Blackboard to bolster the argument that good teaching and good technology are good fits. This paper shows the use of a CMS to augment a traditionally taught course to try to answer the question of effective use of technology in the classroom. Its focus is on the case method and follow-up discussion. The CMS Blackboard features which were used in the case method and discussion were illustrated.

It is hoped that the methods shown here will benefit those who are debating the benefits of using a course management system. The additional preparation of instructional materials and the work involved outside of class on both the instructor's and students' parts may lead to greater efficiency and more effective use of classroom time.

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On Globalizing Management Training: The Role for Business Schools

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Abstract

Globalization is a powerful new force that is shaping today's business environment. While there are many diverse definitions of globalization as there are people taking positions for or against globalization, it is important for us here to focus on the commonalities that are relevant to the practice of management. In line with the conference theme of managing business in a volatile environment and that of balancing local and global challenges, this paper details the demands of globalization for management training and the efforts by business schools to meet those demands. Specifically, the paper argues for a globally portable theory of management based on core competencies, which at the same time, is also sensitive to cultural and contextual contingencies. A model of management training leading to global managerial competence is offered. Specific strategies for business schools and their global implications for management training are discussed.

Introduction

Globalization is a powerful new force that is shaping today's business environment. While there are many diverse definitions of globalization as there are people taking positions for or against globalization, it is important here to focus on the commonalities that are relevant to management. More than anything else, globalization has created one common market for the world's goods and services. Gone are the days when local production serviced local markets and the process repeated itself endlessly around the globe, across sovereign markets in sovereign states. Business schools in those sovereign states provided well-trained managers to meet the expectations of those sovereign markets and manage the firms that serviced those markets. The theory and practice of management driving this process were pretty much localized as well. For example, enterprise management looked and felt very different in China and Vietnam, two countries the author has first hand knowledge of, during the pre-globalization era. There was little comparability between management models of the East and the West. Even within what is conveniently grouped as "eastern" and "western" economies, there were substantial differences in management practice. Now globalization has brought the world under one common economic umbrella (Fischer, 2003). This calls for a general theory of management along with novel approaches and innovative strategies to manage the diversity of expectations and the multitude of interests effectively. Universal core competencies have now become the trademark of globalization.

The management of enterprise under these conditions has acquired a new meaning. In order to manage the process of globalization we need "global" managers. How should we educate them? What should we train them in? What bodies of knowledge are needed to become a successful global manager? How should we organize these bodies of knowledge? What about skills? What are the mechanisms by which we raise managerial competence? In a globalizing world, not only goods and services are portable but so also is knowledge (Moitra & Wensley, 2002). How do we ensure that our global managers possess the knowledge and skills that are globally portable? And what sort of knowledge is globally portable? These are important questions needing thoughtful responses. Arguably, the global enterprises turn to business schools to provide them with the research, education, training and ongoing development.

While the broad goal of business education is to create wealth, it is accomplished through the acquisition of certain core competencies in management. They include learning to assign appropriate value to goods and services and exchange them in the market place at the right price with the right degree of promotion. Managers also learn to maximize return to stake holders through optimal allocation of resources to meet certain goals. They use appropriate strategy and structures to motivate people, provide leadership, build and manage teams, resolve conflicts and at the end of the day, move the organization toward meeting its objectives. Typically, a student of management is equipped with these skills through a systematic exposure to a curriculum dealing with accounting, marketing, finance, operations management, business strategy and organizational behavior. This approach worked well in the pre-globalization period. Now globalization has placed new demands on an old curriculum.

Increasingly business schools are being asked to generate new models for stimulating growth and channeling investment. We are expected to advance knowledge that would promote international trade and facilitate global services. Our students need to become experts in the diffusion of technology. They should be able to transfer knowledge, which would contribute to sustainable development and equitable distribution of wealth. In order to do these things effectively, the global managers must not only possess the more traditional cognitive intelligence but emotional, and cultural intelligences as well (Boyatzis, Stubbs & Taylor, 2002). The notion of multiple intelligence has become more relevant for management training in the globalized environment. It calls for not just old-fashioned “smarts” but emotional robustness and cultural sensitivity to deal with people in different contexts and from different cultures (Early, 2003). In the globalized world, business acumen and managerial competence have become much more pluralistic.

Pluralism poses a peculiar challenge to the practice of management. More than ever before, globalization calls for management skills that are portable and effective in a plurality of contexts and cultures. All of a sudden, we are forced to revisit the very nature of management. Is management a profession like engineering and medicine, with a core body of knowledge that applies pretty much to all situations, embellished, of course by knowledge of local conditions, but essentially portable. Surely, the accent can be placed either on the commonality or on the difference depending upon the situation. Typically for example, there is a core body of knowledge that all physicians or engineers must acquire regardless of where they train. At the same time, someone going to medical school in a tropical country gets greater exposure and training in the treatment of tropical diseases compared to the one going to medical school in the temperate zone. Similarly, for someone going to engineering school, empirical approaches to soil mechanics and foundation engineering change depending upon the geography, but the principles remain the same. In other words, soils differ but the principles of mechanics endure. The question is should management training be anchored around a core body of knowledge driven by certain universal principles? Or should management be treated as a profession like law, substantially localized where the bulk of the training is oriented toward the specific laws of the land where one chooses to practice.

Modeling Management Styles

These questions have serious implications for management training in the context of globalization (Baba, 2002). The model of management now being used to train managers has much in common with the model that is used to train other professionals such as physicians, and engineers. The model suggests that managerial competence is an interactive function of three distinct bodies of knowledge: 1. knowledge generated through research and codified in our texts, journals, and professional magazines; 2. the knowledge that is acquired through experience in management practice; and 3. the knowledge of contexts and situations where one manages. While the model acknowledges that one may possess substantial amount of any or all of this knowledge, it does not guarantee that one has acquired the competence needed to practice management. On the contrary, it is indeed possible that no competence is gained with the mere presence of these bodies of knowledge.

What is needed here is a system that allows for these three bodies of knowledge to interact and inform each other. This is precisely where the training that business schools provide adds value. As shown in Figure 1, managerial competence accrues due to the inter-penetration of the three distinct bodies of knowledge.

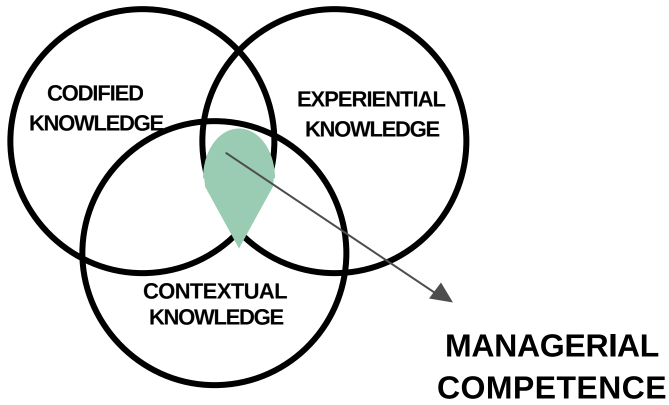

Figure 1. MODEL OF MANAGERIAL COMPETENCE

One becomes managerially competent when one interprets his or her experiences as well as others, in light of the codified knowledge of facts, models, and theories with sensitivity to the context in which it is played out.

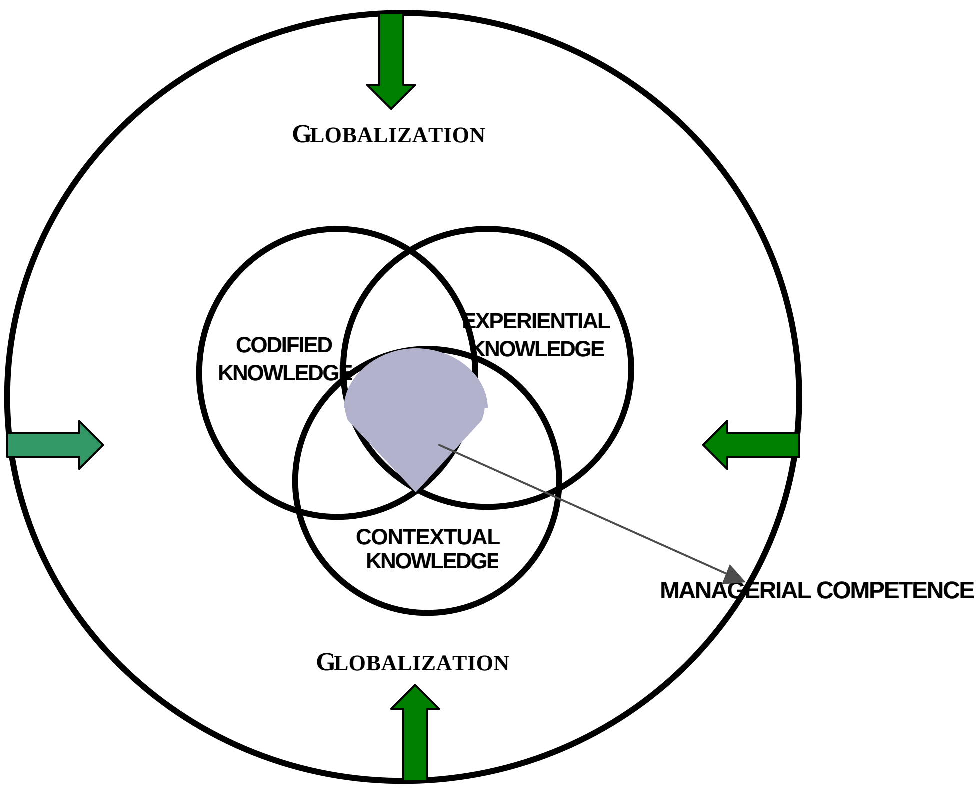

Figure 2. MODEL OF GLOBALIZATION AND MANAGERIAL COMPETENCE

Therefore it is imperative that trainers of managers need to constantly evoke and engender the fusion of these three bodies of knowledge in the classrooms and training facilities. And if the training were to be effective, they should, through pedagogical, strategic, and selective devices, bring the three bodies of knowledge into sequentially tighter relief. What it does is that it expands the area of managerial competence among the trainees. Now, such devices as one may choose to train managers for the global environment, should have the globalization paradigm as the uber-rubric as shown in Figure 2. This is how managerial competence is made relevant to the context of globalization.

The next step takes the process from training to development. Having ensured that the trainee has acquired the cognitive, emotional, and cultural competencies to manage globally, the trainee moves from the classroom to the locale of his or her managerial practice. Here is where the proverbial rubber meets the road. The trainee has an opportunity to apply what he has learnt in a new context, which is quite possibly global, and pick up the skill and facility to practice management effectively. It also affords him or her to adapt and tailor the training to the situation. Once again, the manager experiences the fusion of knowledge, experience, and context, which reinforces the learning, and affords confidence. The competent manager has now become a confident one. From here, the road to managerial effectiveness is short. More importantly, the manager has learnt to learn and the training is giving way to development. He or she is competent to go anywhere and is confident of managing successfully wherever he or she is. The trainee has now developed sound global managerial judgment. What makes management a profession is the fact that in the final analysis, it is the exercise of judgment that matters, although such judgment is well honed through rigorous training and development. It is much the same as in all professions – they are anything but formulaic.

In essence what is suggested here is that the globalization of the world economy calls for globalization of management research, education, and training. That is the only way we could be sure of a steady supply of competent managers around the globe to steer the forces of globalization toward the common good. What is to follow will detail how this needs to be carried out among the business schools with the help of professional associations, chambers of commerce and national governments.

In a rapidly globalizing environment, business schools are increasingly facing the tension between professional standardization and cultural pluralism. They need to train managers who have the core competencies to manage anywhere, and to manage any organization. At the same time, they also need to sensitize their students to the relevance of culture and context for managerial effectiveness. The challenge is to treat them as two sides of the same management coin.

In fact, globalization has forced us, to articulate certain abstract, universal, core principles that would contribute toward a globally portable general theory of management that can give rise to a plurality of models, which are culture sensitive and context specific. The core body of knowledge becomes more robust when enveloped by a theory and as a result, offers empirical synergy in modeling management phenomenon.

This means that we have to work toward a shared view of global commerce and its goals, a shared theory of business, and a shared understanding of the components and processes that constitute global business. It will eventually take us toward a shared theory of management mentioned earlier that will incorporate the context – cultural, economic, political, social, and temporal – within the theory. The final step is to acquire sophistication in developing context-, and content-specific models of management that are needed for the actual conduct of business.

If we are to develop and detail knowledge that is relevant to global management, we need to engage in a lot of empirical research that adds global breadth and conceptual depth to our understanding of business. This research will contribute to a body of knowledge codified for our use in our textbooks and journals. This indeed will form the basis for management education and training.

As for experiential knowledge, what business schools must do is to identify and document a managerial experience profile that is globally relevant. Then, they should recruit both students and faculty who will add breadth and depth to this profile. They function in the classrooms as resource providers. Intellectual and managerial traffic, engineered carefully to maximize experiential knowledge in the classroom is something that business schools can pursue to the benefit of both the students and the resident faculty.

In fact, many business schools in Canada look for requisite variety in terms of the experience profile while recruiting prospective MBA students so that they can inform each other and benefit from each other. The goal is to increase the surface area of the experiential knowledge component of the Venn diagram in Figure 1. It is nevertheless important to keep in mind that increasing the surface area may be necessary to enhance managerial competence but does not deliver it automatically. One needs to bring it in to closer relief with the codified and situational knowledge clusters to achieve enhanced competence. What one needs to do here is to maximize experience along multiple dimensions such as geographic, sectoral, and professional.

As for situational knowledge, what we need is to ensure that the business classrooms have participants with special knowledge of contexts and situations that add unique value to the training mission. We should endeavor to incorporate within the teaching material, knowledge about different cultural, political, social, and situational knowledge that is relevant to global management. As before, the aim here is to increase the surface area of the situational knowledge component of the Venn diagram shown in Figure 1. However, we also need to ensure that it is brought into tighter relief with the rest of the Venn circles in order to have tangible gains in managerial competence.

Finally, as Figure 2 suggests, the paradigmatic lever to bring these three bodies of knowledge closer during the training program is the notion of globalization. Every component in the educational and training program for managers must incorporate within its body of knowledge potential answers to the questions such as what is the theory of globalization that drives the management-training program? What is the relevance of what one had just learnt to globalization? How can the trainee manage better in a globalized environment with the knowledge and skills that he or she is being trained in? What is global about the material being exposed in the training program? How portable are the theories in a global context? How readily do they lend themselves to empirical modeling in different contexts? And to practical applications? This precisely is the role of the uber-rubric or the enveloping circle depicting globalization in Figure 2.

It exerts pressure to seek answers to these questions. The answers may not be readily articulate or even coherent. However, that is not indeed the expectation. The expectation is merely to raise the consciousness of the students and trainees to the notion of globalization and its relevance to management. These are seeds of learning that are sure to grow with time and nurturing.

So far we have laid the groundwork for globalizing management training. The motivation comes from the demands of global commerce to train and develop managers for the global enterprises. The role of business schools is indeed to provide that training. In order to do that, they have to understand the impact of culture on management and incorporate that understanding in their training programs. As scholars of management, we also need to develop models of global optimization and fine-tune a portable theory of management with a view toward contributing meaningfully to international management development.

Suggested Strategies

The next step here is to outline specific strategies that business schools could follow in order to make the management education and training they offer globally relevant. These are presented in Table 1.

TABLE 1. STRATEGIES FOR GLOBAL MANAGERIAL COMPETENCE

Strategies for global managerial competence		
Codified knowledge	**Experiential knowledge**	**Situational knowledge**
Core body of knowledge	Experiential diversity in student body	Globalization of curriculum
Portable theory	Experiential diversity in faculty	International site visits
Context specific models	Use of global managers in the class room	International partnerships and global expert panels
Comprehensive joint empirical research	Executives in residence	International student and faculty exchange programs
Texts incorporating research	Industry professorship	International student internships
Research based training material	Global business cases	International industry sabbaticals
		Off-shore management development programs

These strategies, in a general sense, follow the model outlined in Figure 2. In other words, the strategies contribute toward making the bodies of codified knowledge, experiential knowledge, and situational knowledge globally relevant. More specifically, they focus on the mechanisms to broaden the scope of these bodies of knowledge and bring them into closer relief so as to enhance global managerial competence.

Codified knowledge

The role that business schools play in this area has the potential for maximal impact. Business schools along with global national and international associations of management such as the International Federation of Societies and Associations of Management (IFSAM) can work toward identifying a globally relevant core body of knowledge in management and contribute toward the development of a portable theory of management. In addition, through joint conferences, symposia and workshops, business schools can engage other schools, professional associations, and global industry groups such as the national and international chambers of commerce toward contextually relevant model building and globally comprehensive empirical research. National governments through their research funding agencies can earmark funds for management research of this nature. In fact, the Social Sciences and Humanities Research Council of Canada (SSHRC) has indeed identified globalization and its impact as a national research priority and has set aside funds for generating research-based knowledge on globalization. The business schools should incorporate the knowledge thus gained in the training material that they develop and deliver. Once they have tested them out, the more enduring knowledge coming out of that that process can become the baseline material for globally useful textbooks on management.

Experiential knowledge

The approach here is predicated on the notion that requisite variety is optimally useful in enhancing experiential knowledge. The strategy for business schools to follow here is to ensure experiential diversity among the student body and among the faculty who train them. This strategy has implications for recruiting both students and faculty. The objective here is to maximize opportunities for learning from each other. The approach is to facilitate the training in a manner where each participant's experience becomes everyone else's. In addition, business schools must actively pursue practicing managers in global enterprises to come and share their experiences in the classroom as guest lecturers. Ongoing mechanisms such as executives-in-residence and industry professorships entrench requisite variety, and allows for the full exploitation of experiential knowledge vailable in the community. Finally, the experience profiles of faculty, students, and visiting executives can also be utilized toward developing business cases that can further contribute to the effective globalization of management training.

Situational knowledge

As in the previous case, the plan here hinges on the notion that exposure to a variety of situations and contexts and interpreting the best practice of management in light of that knowledge allows for effective management training. An important step here is to globalize the management curriculum. This is also where accreditation bodies like the Association for the Advancement of Collegiate Schools of Business International (AACSBI) and EFMD (European Federation for Management Development) can help. They could enforce global relevance and international portability in the curricula of business schools. This would ensure the commonality of a core body of knowledge that all accredited management education programs would incorporate in their training schemes. A popular way by which many business schools operationalize the globalization of the curriculum is to incorporate an international tour and site visits as part of the program requirements. Students and faculty choose a particular area of the globe to concentrate and then organize a visit to that country, which includes both business and cultural exposures. This gives the students a first hand knowledge of the context in which global organizations function.

Other mechanisms by which the situational knowledge is made available to students and trainees of management include the formation of international partnership with other business schools around the globe. One could also extend such linkages to global industry associations and international chambers of commerce. Such partnerships will make relevant situational knowledge readily available to all partners. More importantly, they make each other aware of changes taking place in their respective environments. This can be further operationalized through the formation of a global expert panel on various topics on management, which consists of both faculty and practicing managers trans-globally drawn from the partnering schools and organizations with the mandate to update knowledge – textual, experiential and situational.

Related strategies include international exchange programs and international internships for students, and an international visiting scholars program for faculty. Business schools could also encourage their faculty to take their sabbaticals in global organizations so that they can expand their profiles of both experiential and situational knowledge to the benefit of future trainees. Another approach that many business schools use to round out the situational knowledge of their trainees is to offer off-shore management development programs including an Executive MBA with on-campus visits where students in both programs have an opportunity to learn from each other (Baba & Dadgostar, 2003).

Once again, it is important to stress that global managerial competence can be accomplished only by bringing these three bodies of knowledge into closer interaction through the common optic of globalization. Globalization is a strand that should be woven through the fabric of management training. Pluralistic learning models, innovative pedagogy, global class rooms facilitated by information technology can all become patterns in the fabric, making it both unique and useful.

Conclusion

In summary, this paper outlines the demands of globalization for management education and training. In line with the conference theme of managing business in a volatile environment and that of balancing local and global challenges, this paper details the efforts by business schools to meet those demands. Specifically, the paper argues for a globally portable theory of management based on core competencies, which at the same time, is also sensitive to cultural and contextual contingencies. A model of management training leading to global managerial competence is offered. Specific strategies for business schools and their global implications for management training are discussed.

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A Study Knowledge Conversion Practices in Selected Firms

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Abstract

In the new millennium, organizations begin to pay attention to knowledge management and how a knowledge-based organization can gain competitive advantages in the competitive environment. Organizations must be more innovative, more agile, and smarter in order to compete in this twenty-first century world. Those organizations that cannot learn, adapt, and change will not survive in this new millennium. So the leaders of the organizations must be progressive to create added value and generate value from knowledge assets in their organizations. The assets of the companies are categorized into tangible asset and intangible asset. Tangible asset such as property, equipment, plant, inventory, and financial capital are considered the most fundamental company asset. Intangible assets are knowledge, brand, and relationship with the customer. Apparently, most of the organizations still focus on their tangible assets because tangible assets are objectively evaluated quite easily. For instance, the financial statement is used to reflect whether the company makes profit in their business or otherwise. However, without related knowledge and skills in the business -related field of the workforce, the company won't be able to succeed. In this study of knowledge conversion practices in three manufacturing and one service firms, it was discovered that not all knowledge conversion practices were fully implemented in these four firms. These knowledge conversion practices were: socialization, externalization, combination, internalization. One-way ANOVA test showed there were significant differences among four firms in terms of socialization, combination and internalization.

Introduction

Knowledge management has become an important tool in staying ahead in the competitive environment. Often, organizations are taking a great interest on the idea of knowledge management and many of the organizations implement these programs in their organizations. The external forces such as globalization have force the organizations to speed up their technological innovation processes and to exploit the synergetic properties intangible assets Besides, the market globalization has reinforced the organizations the need to differentiate, to exploit the advantages derived from selective integration of core competence and to lever intangible assets (Bustamante, 1999).

It has been suggested that the success of business in an increasingly competitive marketplace depends critically on the quality of management which those organizations apply to their key business processes (Macintosh, Fily & Kingston 1999). With related knowledge it will allow the organizations to exploit the opportunities in the market and toward competitive treats. For example, the supply chain in a manufacturing environment depends on knowledge in diverse areas including raw material planning, manufacturing process and distribution of finished goods. Thus, the supply chain management is one of the most important strategic aspects of operations which encompasses many related functions. It will help the organizations to make decision on: from whom to buy the materials; where to locate facilities; how to transport goods and services; and how to distribute them in the most cost-effective, timely manner. According to Drucker (1999), the highly successful Japanese companies such as Honda, Canon, Matsushita, NEC, Sharp, and Koa make their companies more competitive in the competitive environments. The key to success of these companies are their ability in managing their creation of new knowledge.

Knowledge management has existed for many years, but only within the past few years it has gained noteworthy attention (Audrey and Robert, 2001). Many organizations are now pursuing knowledge management strategy because they believe that knowledge management is the central to their ability to grow and compete (APQC, 1999). According to Harrison (2000), the survival and innovation of companies are nowadays not only dependent on the knowledge they have but on the ability to generate new strategically valuable knowledge. Thus, the organizations must be able to use their knowledge resources to produce goods and services in order to increase their products at higher value. All in all, the capabilities and sustainable competitive advantage of one organization come from its continuously developing existing resources and capabilities, creating new resources and its ability to response to the market change.

What Is Knowledge?

According to Zelenny (2001), knowledge is the primary form of capital for the organizations. All other forms are dependent derived, only secondary to knowledge. For example, if we have a peace of land, without the knowledge how could we develop and make added value to that peace of land? So individuals need knowledge to help them to create innovation, which can help them to generate and increase the value their tangible asset. With the related knowledge, such piece of land can be developed as an industrial zone, a business center, a condominium and many others that can create added value to the land. As such, the company needs to recognize that knowledge is an asset, to be looked after used, and be valued like any other assets. Consequently, every company needs a policy of knowledge management (Bagshaw, 2000) that will help the company to ultimate their assets in order to become more competitive among the competitors.

It is however very difficult to define knowledge because of its intangible and fuzzy nature. It is the major problem for us to delimit the concept of knowledge. What is knowledge for one person can be information for the other (Bhatt, 2002). At present, there are numerous definitions of knowledge, but none seem to be universally appropriate, as these definitions depend on the context in which they are used (Bender and Fish, 2000, quoted in Sveiby, 1997). Since knowledge is "everything", it can be an encyclopedia that concerns the facts about the world. It also can be social, i.e. telling people about when to use the encyclopedia, a procedural knowledge (Alvesson and Karreman, 2001). Marakas (1999) also agreed that knowledge is an organized combination of ideas, rules and procedures.

Knowledge is characterized by information, a capacity and an attitude which is very important because all these three factors are equal and require sufficient attention. Knowledge is also said the result of multitude of factors: experience, skills, culture, character, personality, feelings, etc (Beijerse , 2000, p.164).

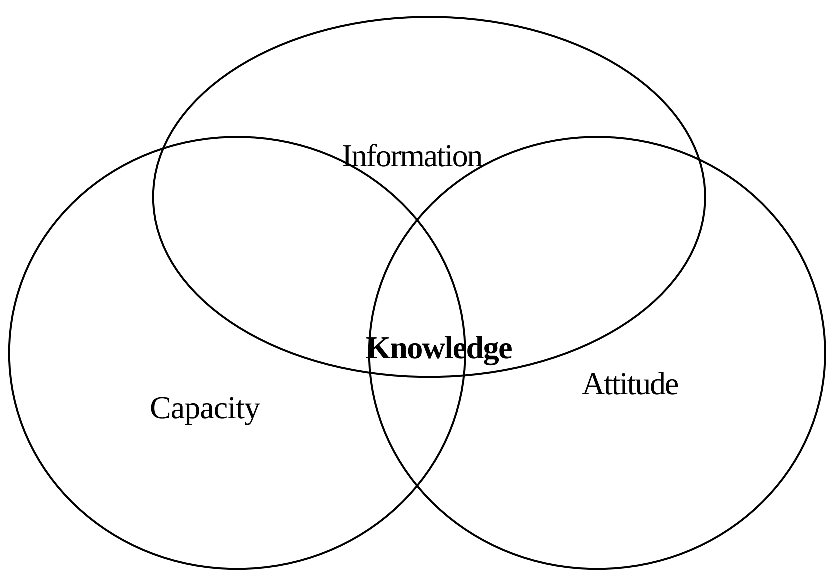

Figure 1 Three facets of knowledge Beijerse, 2000

From the above Figure 1, it shows that knowledge forms by three characters: information, capacity and attitude.

Information

Knowledge is an amount of information what is necessary to function and achieve. It is very hard to define what the information is. The information must easily accessible within the organization and accessible for everyone.

Capacity

The capacity is to make information from data and to transform it into useful information. This capacity such as creativity interprets and acts. With this knowledge, it will allow us tapping into and developing that which people are good, what are called their core competencies.

Attitude

Knowledge is an attitude. It is the attitude that make people want to think, interpret and act. It is important to stimulate people's curiosity and innovation to innovate

Standards Australia (2001, p.18) provided conceptual definition of each term summarizing a wide literature, combined with a working definition in knowledge management framework, which is data information, knowledge and wisdom (Clarke and Rollo, 2001, quoted Standards Australia 2001, p.18). This is shown in Figure 2 below.

I

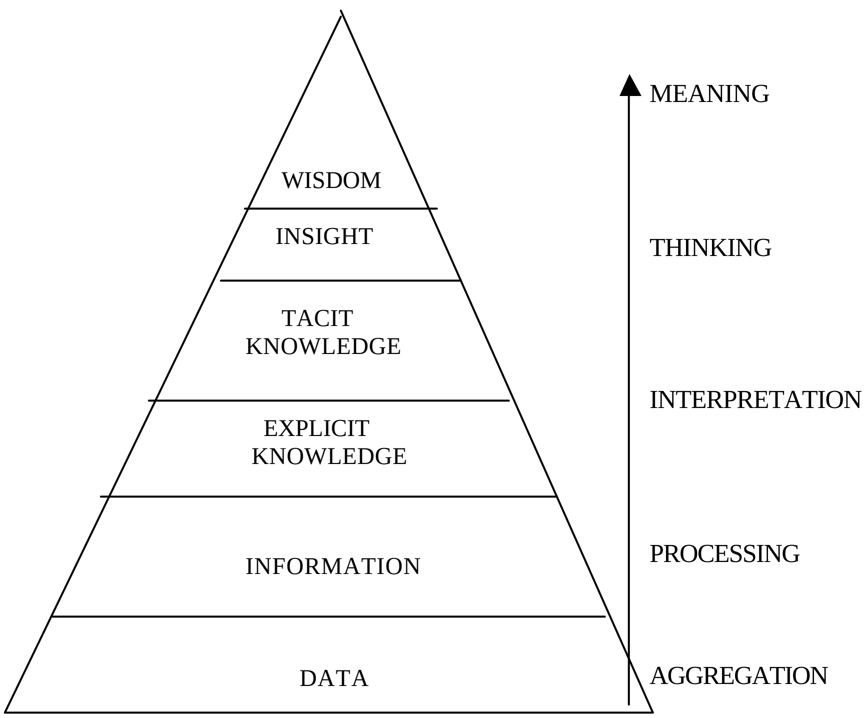

FIGURE 2 Data, Information and Knowledge, Standard Australia 2001

Nonaka and Takeuchi (1995), discuss four modes of knowledge in their models that discuss the distinction between tacit and explicit in four basic patterns for creating knowledge in any organizations.

Socialization: From Tacit Knowledge to Tacit Knowledge

Socialization is the process of sharing experiences, and creates tacit knowledge such as shared mental and technical skills. The tacit knowledge is acquired directly from others without using language such as observation, imitation, and practice. "On-the-job training' is one of the basically principles to acquire tacit knowledge. The key to acquire tacit knowledge is sharing experiences among the members in the organization. They shared their knowledge and experiences through brainstorming session, informal meeting, gathering and resort, meet at outside workplace, drinking, sharing meals and many others. They can discuss and critic on the topic they discuss. Beside they can acquire the tacit knowledge from their customer. Interaction between the products developers and customers will help them shared their knowledge and create new ideas for improvement.

Externalization: From Tacit Knowledge to Explicit Knowledge

Externalization is the process that makes the personal or tacit knowledge into explicit form such as metaphors, analogies, hypothesis and models. The externalization mode of knowledge conversation can be seen in the process of concept creation and conversation or collective reflection. Normally the method that is frequently used to create concept is to combine deduction and induction approach. Externalization holds the key to knowledge creation, because it creates new, explicit concept from tacit knowledge. Example, in the externalization, a metaphor is used to perceive and intuitive and to understand one thing by imaging another thing symbolically.

Combination: From Explicit Knowledge to Explicit Knowledge

Combination is the process of systemizing concepts into a knowledge system. In this stage, individuals exchange and combine knowledge through documents, meeting, telephone conversation, or computerized communication networks. The new knowledge can be created through configuration of existing information such as sorting, adding, combining, and categorizing of explicit knowledge. Combination is the process of knowledge creation that can carry out in formal education and training at school such as MBA education at a university. Other example, the managers break down and operationalizes the corporate vision, business or product concepts. They create the new concepts through networking of codified information and knowledge such as using computerizing communication networks and large-scale databases facilitate as a mode of knowledge conversation.

Internalization: From Explicit Knowledge to Tacit Knowledge

Internalization is a process of embodying explicit knowledge into tacit knowledge. This can happen through 'learning by doing'. Example, the experienced workers internalize their working experiences and make use of their know-how and learning for R&D projects in the company. The explicit knowledge becomes tacit knowledge when knowledge is verbalized or diagrammed into documents, manuals, or oral stories. When the individuals read this information, it will help the individuals enrich their tacit knowledge through documentations. The documentation will transfer the explicit knowledge to the individual indirectly in order to help them experiencing the experience of other people. Internalization also can happen when individuals reading or listening to a success story of some members of their organizations. It will make them feel the realism and essence of the story. They past experience of the successful members in the organization may help them change the explicit knowledge into tacit knowledge.

Objectives of the Study

Knowledge management programs sometimes failed in the organization. The occurrence of the knowledge management practices problems in the organizations had led to many of the organizations are not fully practiced all the knowledge management and knowledge conversion in their organizations. One of the reasons is that most organizations still measure their company performance based on the tangible capital they spend on, the economic returns from those investment and they can't realize the value of their intangible capital, i.e. knowledge. Besides, there are organizations which do no have initiatives to encourage their employees to practice knowledge management in their organizations. Against this background, using the Knowledge Management framework in Figure 2 (Standard Australia 2001), this study seeks: to investigate which knowledge conversion practices are fully practiced? The knowledge conversion practices are: socialization, externalization, combination, internalization.

Significance of Study

Knowledge management is very important to the organizations because knowledge is essential to the development of the organizations. Knowledge is the factor that the organizations distinguish themselves from their competitor.

Knowledge will also help the organizations to increase their profitability, productivity, and competitive advantages. This study on knowledge conversion practices in organizations will help the organizations to fully utilize the knowledge and the skills of their employees, to capture their ideas that contribute to their organizations. This study also helps the organizations in exploiting their intellectual capital effectively by using the most appropriate methods for transforming the requisite intellectual capital to the best form needed in the challenging market. After all, knowledge is characterized by information, a capacity and an attitude which is very important because that all three of these factor are equal and sufficient attention.

Methodology

This study was on knowledge management practices in four selected firms in Malaysia: three manufacturing firms and one services firm. The study investigated the gaps between the organizations which participate knowledge conversion practices in their organizations.

Tacit Knowledge To Tacit Knowledge (Socialization), Tacit Knowledge To Explicit Knowledge (Externalization)
Explicit Knowledge To Explicit Knowledge (Combination), Explicit Knowledge To Tacit Knowledge (Internalization)

The questionnaires were adapted from Filius et al. (2000), Beijerse (2000). The close-ended questionnaires using five-point Likert scale to indicate the respondent's extent of their answer, (5= completely agree, to 1= completely disagree) were distributed to the representative according to their managerial levels: top management, middle management, and supervisors. Mean scores of the knowledge management dimensions are used to indicate the knowledge management practices in each of the organization. One-Way ANOVA test was used to test the significant differences of knowledge conversion practices among four firms. The obtained data from the respondents is analyzed by using SPSS 11.0. The secondary data obtained from books reviews, articles, journals and website. The secondary data provides additional sources to support the results of the research. All of the questionnaires were distributed to the four selected organizations were successfully collected back from the organizations. This meant that 100% of the questionnaires were collected back from the respondents from the selected organizations. It was found that the respondents gave the positive feedback in this study. They were also willing to share their knowledge and opinions regarding the knowledge conversion practices in their organizations.

Findings

This research analysis aimed to investigate the extent of knowledge management practices and gap in the selected company. Twelve sets of questionnaires have distributed to the four selected companies. Three staff members of each organization from different position are invited to participate in this study. Mainly they are top management, middle management and supervisors. Table 1 and Table 2 show the samples of firms and respondents

TABLE 1 NUMBER OF RESPONDENTS BY COMPANY

	Firm Types	Size (employees)
Firm A	Assembly and technical platting services	850
Firm B	Packaging, Testing and 'turnkey" services	2,275
Firm C	Computer Systems	2,000
Firm D	Telecommunication services	1,123

Company

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Company A	3	25.0	25.0	25.0
	Company B	3	25.0	25.0	50.0
	CompanyC	3	25.0	25.0	75.0
	Company D	3	25.0	25.0	100.0
	Total	12	100.0	100.0	

TABLE 2 NUMBER OF RESPONDENT BY POSITION

Position

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Top management	4	33.3	33.3	33.3
	middle management	4	33.3	33.3	66.7
	supervisor	4	33.3	33.3	100.0
	Total	12	100.0	100.0	

Knowledge Conversion by Companies

From the Table 3, the conversion of knowledge practices from explicit knowledge to explicit showed the mean score of 3.60 is the highest among the four items in knowledge conversions. Socialization of knowledge mean = 3.58 is second higher after combination knowledge follows by externalization of knowledge =3.51, and internalization of knowledge =3.51.

TABLE 3 KNOWLEDGE CONVERSION PRACTICES BY COMPANIES

	Company A	Company B	Company C	Company D	Mean
Tacit Knowledge To Tacit Knowledge (Socialization)	**3.64**	**2.98**	**3.80**	**3.90**	**3.58**
Tacit Knowledge To Explicit Knowledge (Externalization)	**3.48**	**3.43**	**3.48**	**3.67**	**3.51**
Explicit Knowledge To Explicit Knowledge (Combination)	**3.33**	**3.27**	**3.90**	**3.90**	**3.60**
Explicit Knowledge To Tacit Knowledge (Internalization)	**3.22**	**2.67**	**3.53**	**3.69**	**3.28**

1.1. Socialization: Tacit Knowledge to Tacit Knowledge

In the socialization of knowledge practices, for Company D the mean score= 3.90 is the highest among the four companies. Company C mean= 3.80 was the second highest after Company D follow by Company A mean=3.64 and Company B mean= 2.98. The mean gap in socialization of knowledge for Company B with Company D was higher if compare with Company A and Company C. The mean gap between Company B and Company D was 0.92.

On the other hand, the mean gap between Company C and Company D was 0.10, and the mean gap between Company A and Company D was 0.26. The mean gap for Company B is higher compared with Company A and Company C.

TABLE 4 ONE WAY ANOVA FOR SOCIALIZATION OF KNOWLEDGE PRACTICES AND COMPANIES

ANOVA

Socialization:From Tacit Knowledge To Tacit Knowledge

	Sum of Squares	df	Mean Square	F	Sig.
Between Groups	1.580	3	.527	11.797	.003
Within Groups	.357	8	.045		
Total	1.937	11			

There were significantly differences between socialization of knowledge practices or tacit knowledge to tacit knowledge with companies. One-way ANOVA test showed F=11.797 and P>0.05. The result showed there were significant differences among four firms.

1.2. Externalization: Tacit Knowledge to Explicit Knowledge

We found that in the externalization of knowledge practices, the companies mean in this item are very closed within each other in between 3.43 to 3.70. Of the four companies, Company D mean =3.67 was the highest in the externalization of knowledge practices. On the other hand, Company B mean =3.43 was the lowest among the four companies. There were two companies scored the same mean= 3.48. There were Company A and Company C. The mean gap among these four companies are smaller and less than 0.25. The mean gap between Company D and Company B is 0.24, and the mean gap for Company A and Company C were equal to 0.19 when compared with Company D.

TABLE 5 ONE WAY ANOVA FOR EXTERNALIZATION OF KNOWLEDGE PRACTICES AND COMPANIES

ANOVA

Externalization: From Tacit Knowledge To Explicit Knowledge

	Sum of Squares	df	Mean Square	F	Sig.
Between Groups	.100	3	.033	.187	.902
Within Groups	1.429	8	.179		
Total	1.529	11			

One-way ANOVA was used to test whether externalization of knowledge practices significantly differences with companies. From the above result F=0.187 and p>0.05, found that there were no significant differences between externalization of knowledge practices and companies.

1.3. Combination: Explicit Knowledge to Explicit Knowledge

Company C and Company D scores the same and highest mean 3.90 in knowledge combination practices among the four companies. Company A mean 3.33 is second highest after Company C and Company D. Company B mean 3.27 is the lowest among the four companies.

TABLE 6 ONE-WAY ANOVA FOR COMBINATION OF KNOWLEDGE PRACTICES AND COMPANIES

ANOVA

Combination: From Explicit Knowledge To Explicit Knowledge

	Sum of Squares	df	Mean Square	F	Sig.
Between Groups	1.087	3	.362	4.179	.047
Within Groups	.693	8	.087		
Total	1.780	11			

To test whether there were significantly differences between combination of knowledge practices and companies, the result showed that $F=4.179$ and $p>0.05$ and that there were significant differences between combination of knowledge practices and companies.

1.4. Internalization: Explicit Knowledge to Tacit Knowledge

Company D scores the highest mean 3.69 among of the four selected companies in the internalization of knowledge practices. On the other hand, Company B mean= 2.67 was the lowest among the four companies. Company C mean =3.53 was the second higher after Company D follow by Company A 3.22. The mean scores gap between Company B and Company D was high if compared with other companies. The gap between Company B and Company D was 1.02. On the other hand, Company A and Company C mean gap when compared with Company D were 0.47 and 0.16 respectively.

TABLE7 ONE-WAY ANOVA FOR INTERNALIZATION OF KNOWLEDGE PRACTICES AND COMPANIES

ANOVA

Internalization:From Explicit Knowledge To Tacit Knowledge

	Sum of Squares	df	Mean Square	F	Sig.
Between Groups	1.838	3	.613	8.207	.008
Within Groups	.597	8	.075		
Total	2.435	11			

In order to test whether they are significantly differences between internalization of knowledge practices and companies, one-way ANOVA test showed the result of $F=8.207$ and $p>0.05$. Thus, there were significant differences between internalization of knowledge and companies.

Conclusion

Explicit Knowledge and Tacit Knowledge

Knowledge can be conceptualized as tacit knowledge and as explicit knowledge (Gupta, Lyer, and Aronson, 2000). Explicit knowledge is based on universally accepted and objective criteria. It has the character of public good and easy to code and transfer. According to Hedlund (1994), explicit or articulate knowledge is specific as being writing, drawings and computer programs. It means that its can expresses as a word of number, in the form of hard data, scientific formulas, manuals, computers file, documents, patents and standardized procedures or universal starting points that can easily be transferred and spread (Beijerse, 2000).

Explicit knowledge can resides in formulae, textbooks or technical document (Lee and Yang, 2000). It is also can share the knowledge through printing, electronic methods and other formal means. Besides explicit knowledge is carefully codified, stored in a hierarchy of databases that can be reused to solve many similar types of problem (Smith, 2001). According to Emin civi (2000), explicit knowledge can be expressed in words and numbers and shared in the form of data, scientific formula, specification and manual. It can migrate in the business community, and be accessible for the most company regardless of their cooperatitive activity. This codified and stored explicit knowledge can be accessed and used easily by anyone in the organizations.

Polanyi (1962) defined tacit knowledge as the knowledge that is non-verbalizable, intuitive, and unarticulated. Tacit knowledge usually in the domain of subjective, cognitive experiential learning, whereas explicit knowledge deals with more objectives, rational, and technical knowledge (data, policies, procedures, software, documents etc) (Gupta, Lyer, and Aronson, et al., 2000). Badaracco (1991) conceives of tacit knowledge as existing in individuals or groups of individuals. He refers to such knowledge in individuals and social groups as embedded knowledge.

Tacit knowledge is learned through collaborative experience and it is difficult to articulate, formalize, and communicate (Nonaka and Takeuchi, 1995). Tacit knowledge is the knowledge in a person's head that is often difficult to describe and transfer. It includes lessons learned, know-how, judgments, rule of thumb, and intuition (Grayson and O'Dell, 1998). Tacit knowledge is the skills and "know-how, we have inside each of us that cannot be easily shared (Lim, 1999).

Tacit knowledge is deeply rooted in an individual's actions and experienced as well as ideas, values or emotions. Tacit knowledge can be classified into two dimensions, which is technical and the cognitive dimensions. The technical dimension encompasses information and expertise in relation to "know-how" and the cognitive dimensions consists of mental models, beliefs, value, schema, and ideals (Gore and Gore, 1999).

The results of this study showed that the extent of knowledge conversion among the four companies are different between each other. All in all, not all four companies fully practiced those four categories of knowledge conversions.

Limitation of the Study

This is a case study that attempts to explore knowledge conversion practices. The results of this research do not reflect an overall actual situation in all companies in Malaysia. It is hope that further rigorous research in knowledge management practices in Malaysian-based companies are conducted. we can know the extent and the weakness we are, so we can improve it through the research.

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Contact the author for a list of references.

Online Learning: Crossing of Boundaries Courses
A Mexican-UK Comparative Case Study Analysis

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Abstract

Although e-learning has been an important topic within education and training for more than a decade, it is probably fair to say that the development of this style of learning is still evolving. Using data from two research projects, one carried out in the UK and one in Mexico, this paper focuses upon four elements that most affect the learner experience and ultimate success of teaching practice. These elements, which need to be taken into consideration when developing e-learning courses, are listed as: the delivery of the pedagogic method of virtual learning itself, the role of the instructor, the software used, and the experience of team teaching. Base on the two case studies, this paper analyses the strengths and weaknesses of elearning through the lenses of the elements listed above. Although the researchers involved do not reach any final conclusions, the paper emphasizes the importance to analyze the learner experience when embarking in online learning. The research found that once the student is engaged in the elearning experience, the pathway to successful learning is established.

Introduction

The use of information and communication technologies (ICT) in the delivery of education has major implications for lecturers, learners and higher education institutions (HEI). Whilst there is potential for major benefits for all concerned, it also continues to set a challenge for providers to develop new strategies for teaching and learning and raises fundamental questions about the learning process. Within the UK, a debate still flourishes on whether electronically-based education will enhance student learning and be more cost effective for institutions or pose a risk in both financial and pedagogic terms (Bacshich &Ash, 1999, Sloman, 2001). As van der Wende (2001) points out, regarding the implementation and effects of ICTs, a variety of differing views and opinions have emerged. One end of the spectrum perceives ICTs as “really changing education”, while there is an opposite view that ICT has “little effect”. But what is the opinion of those most affected by this revolution namely the learners? And how can such information be used to inform and support international cooperation in allowing full maturity of the e-learning industry to evolve?

Literature Review

E-learning has yet to be widely accepted as the term to describe technologised learning in all its forms. Authors agree that a single definition for eLearning has yet to be found (Selinger & Pearson, 1999; Sloman 2001; CIPD report; 2001; Rosenburg, 2001). A range of terms such as ‘tele-learning’ (Collis, 1996), ‘telematics’ (Selinger & Pearson, 1999), ‘online learning’ (Salmon; 2000), ‘distributed learning’ (Bates 2000), ‘flexible learning’ (Collis & Moonan, 2001), may all point to a similarly conceived educational experience.

The concept of e-learning suffers from the fact that it has numerous definitions and interpretations. Deciding upon which definition fully encapsulates the concept is not an easy task. At a basic level it can be defined as the use of technology to delivery or support learning. E-learning bridges distance, but goes beyond anything that conventional distance learning offers (e.g. through correspondence or CD ROM courses). For Rosenberg (2001) it is based upon three fundamental criteria:

1. It is networked, capable of instant updating, storage/retrieval, distribution and sharing of instruction and information.
2. It is delivered to the end-user via a computer – using standard internet technology

3. It focuses on the broadest view of learning – learning solutions that go beyond the traditional paradigm of training

This definition appears to be endorsed by other (McFadzean & McKenzie 2001; Salmon & Giles 1998) who describe the learning through computer-mediated communication (CMC) as the transmission or reception of information through a networked computer system using Web-based or collaborative software.

Collaborative learning occurs when learners use this technology to interact with each other and to gain access to a wide variety of resources. It is the potential it offers to learners for collaborative working and in accessing an almost infinite, reconfigurable and constantly updated information source, perhaps structured around a core course delivered by lecturers/facilitators that constitutes the major strength of e-learning. However, when developing electronically delivered courses tapping into the learner experience to gain an understanding of the weaknesses must be given equal consideration as the strengths (Bruffee, 1999).

In linking issues which have appeared in the literature with the empirical findings, the four following categories have emerged:

1. Strengths and weaknesses of e-learning courses
2. Instructor and student interaction
3. Different models of learning delivery
4. Experience of team teaching

And these specific issues will be discussed below.

Strengths and weaknesses of virtual learning

There is a perception that the use of ICT in education will be of benefit in higher education institutions. However, good use of ICTs is failing to occur because of a lack of comprehensive policies and strategies. Courses run using ICTs tend to be isolated experiments and pockets of good practice and are not part of a whole university based plan. (Collis, 2001). Literature on the subject (Appleborne, 1999; Bates, 1995; Harasim, 1994) suggest the following as major strengths and weaknesses.

Strengths	***Weaknesses***
Knowledge Generation: The instructor becomes a facilitator in the educational process. The learner takes responsibility to retrieve information and knowledge and use facilitator's guidance in a meaningful way.	Work overload occurs on part of students in having to access information themselves and through working more independently.
Collaborative learning: The learners develop together original thought as they build their own knowledge and meaning.	Time restrictions, culture differences and other difficulties have been found when distance students need to engage in collaborative learning with distance partners
Customised approach which focuses learning and administration on student rather than institutional needs	In many traditional universities there still exists a lack of institutional vision-policy for the integration of ICTs into teaching programmes. Leads to a discrepancy in the quality of learning experience.
Close relationship between learning and the work, leisure, professional or other requirements of the student	When the process of learning takes place in a work environment, difficulties of time compatibility were found among students
Universities would be forced to develop better products	Traditional universities are by nature collegial and zealous defenders of their culture and traditions
Universities have adopted a focused student-centred approach rather than having a curriculum, instructor and course orientation.	Universities are not taking sufficient account of the changing nature or the student body and the flexibility in learning they now demand.
New educational markets that will cut across age groups and national boundaries	Global competition poses a threat to institutions unwilling or unable to participate in the e-learning revolution

Instructors and students interaction

Perhaps the most important factor that e-learning has brought to the instructor – student relationship is the level of flexibility of interaction and communication. Instructors are freed from both time and geographic constraint and are able to contact students whenever they wish, from wherever they wish, answer questions and even mark and give results of assignments. For the students, the possibility of accessing the instructor through e-mail or other asynchronous software allows them to organize their time schedule. Learners can save communications, forward messages to other students, contact and communicate with the instructor when he/she is away. Distance and time are rapidly becoming irrelevant in the teaching process and hence no longer a barrier to the learner or the instructor.

Different Models of learning delivery – computer conferencing and website

Online learning could be delivered through the use of different course authoring tools, such as WebCT or Blackboard or in combination of other computer-mediated technologies, such as computer conferencing (Pallof & Pratt, 2001). Computer conferencing capacitates the development of a time and location-independent learning environment that with the use of images and sound may simulate educational interactions, both cognitive and affective, that occur on-campus. Harasim (1990) underlines that computer conferencing has found important practical application in education, including delivery of university and graduate credit courses. Computer conferencing was first employed for educational delivery in 1982 (Freenberg, 1987).

Experience of team teaching

Johns (1996) underlines the importance for “new model universities” to operate in a variety of partnerships. In fact one of the key differences between traditional modes of teaching and virtual ones, is the fact that a virtual (online) lecture is produced by a team. This team is formed by a group of people who are in charge of the different elements to design an electronic course, such as the instructor, the website designer, the instructional designer, etc. By doing team teaching, the instructor is not longer the ‘knowledge holder’ as he/she shares this knowledge not only with the team but also with the learners.

Students and instructors use of the Internet for virtual learning

The access and use of the Internet that e-learning provides represents for the learner a possibility of interaction with different sorts of activities provided by the website. Groups come together outside the university environment and share workplace tools. Furthermore, the Internet provides learners with different sorts of software and different source of information that facilitates the course enrichment and the interaction with distance colleagues.

As Harasim suggests, apart from enhancing and expanding educational access, “computer-mediated communications suggest significant potential for effective new learning and research interactions”. (Harasim, 1994).

Students may connect, using the Internet, with experts in their field of study, other universities, and learning communities, or discussion groups that have form around interest in the area under study. As they do this, their ability to use these skills while working in other course areas also increases. (Paloff & Pratt 2001).

Empirical evidence
The Mexican experience.

Research was carried on in Mexico at the Monterrey Institute of Technologies (ITESM) during August - November 2000, and October 2001. The ITESM is a Mexican private university with 30 campuses in Mexico and 9 other countries in Latin America. Founded in 1943 by a group of Mexican entrepreneurs, computers were incorporated in their teaching process since 1997.

The ITESM as a university using technologies is innovative as it does not only use one technology at a time (TV, video, computers…) but uses multiple technologies simultaneously, covering more than 70,000 students. The ITESM is the only Mexican university massively applying the use of computers into their teaching model. This use of computers seeks the interaction between lecturers and learners through a computer mediated learning process. Undergraduate students receive their lectures through a mixed mode that combines teleconferencing lectures with website courses. Registered students in the first and second year of their bachelor degrees, use a mixed face-to-face and computer-supported mode while registered students at the third and fourth year cohorts use a combine on-line/teleconferencing mode.

Open- ended interviews were conducted with both distance students and virtual lecturers in the Department of Engineering and Computer Sciences and the Department of Management and Business. Students were asked about their skills and confidence to use computers, their interaction with the distance instructor, their participation in on-line learning, engagement and motivation in collaborative work and future benefits of the use of technologies in the workplace.

Strengths and weaknesses of virtual learning

Even though lecturers and students stated that the teleconferencing/online mode demands from them more work, they both agreed regarding the advantages that this kind of teaching and learning brings compare to traditional modes. Similar findings to those of Linda Harasim (1994) showed that not only the fact that in the new model lecturers are now considered more like facilitators and not like knowledge holders, but also the possibility of students to access an enormous amount of information was underlined as important. Furthermore, students in this model engaged in collaborative work activities with their distance partners and participated in group discussion.

Instructors and students interaction

Technologies' presence in the lecture room was considered of vital importance regarding the possibility of interaction between the virtual lecturer and the student. In the so-called "virtual lecture room", students received a lecture from a distance instructor who would transmit it through teleconference. Inside the lecture room, students will have a TV monitor with a satellite connection to the remote site, a computer with connection to the Internet and a telephone line. Therefore communication with the lecturer was seen as permanent as students may contact their instructors through e-mail as often as they needed to, either during the lecture itself, or after it. Most of the interviewed instructors agreed that their distant students value a permanent contact with them. However, distance students complained that the interaction with their lecturers was not as efficient as it should be and that virtual lecturers should attend the work of more than five hundred students at once.

Different Models of learning delivery – teleconferencing and website

At the ITESM, a mixed mode to learning delivery was used. The lecture was transmitted in a computer conferencing mode and students accessed the course materials through a website. Students spent 3 hours a week inside a virtual room where they received the satellite transmission of the lecture and complemented this session with readings and research done in the web. Furthermore, they also engage in collaborative activities with distance colleagues through the use of this web.

The experience of team-teaching in a virtual mode

In the case of the ITESM this team was formed by the lecture him/herself, one or two instructional designers, two or three tutor lecturers and course' facilitators in each campus. The lecturer responsible for the course is no longer working on their own. Most of the interviewed lecturers agreed that even though working within a team was challenging for them (because they have to develop innovative pedagogic techniques), it was an enriching experience that made them realized their new role in the distance lecture room. As lecturers stated, in order to work in team they have to complement each other regarding the knowledge of the field they are teaching. They emphasised the importance of co-operative working.

Students' and lecturers' use of the Internet for teaching and learning

All of the interviewed distance lecturers and students agreed that the Internet played a crucial role in the process of teaching and learning in this teleconferencing/online mode. Apart from the web content, distance lecturers placed several links to other relevant sites where students could find interesting information regarding their courses. Furthermore, students use permanently research engines to look for information relevant to their courses. The interviewed distance lecturers underlined the importance that the process of innovating hardware and software had in the improvement of a virtual lecture. Both lecturers and students stated that the use of electronic methods of interaction - like ICQ or chat spaces – made possible the synchronic and asynchronic interaction between students and their distance lecturers.

The UK experience

The Centre for Research in Innovation Management (CENTRIM) is a research department located in the University of Brighton in the UK, a university catering for twelve thousand students. CENTRIM, in collaboration with eight other universities and organisations within the UK, was responsible for developing and delivery of two courses Training in Supply Chain Management and Training in Innovation Management Europe (TISCAM and TIME) as part of an e-learning research project funded by the European Union. Each course consisted of ten modules of learning, each module having ten units to be covered over a period of 10-20 weeks.

CENTRIM took the opportunity to approach the project from a variety of different levels. Firstly, it was an experimental learning process for all concerned in the creation of electronic learning materials; secondly, it was research oriented, designed to test out the methods of authoring and gaining an understanding of the learner experience in work-based situations; and thirdly the project could be seen in terms of a collaborative innovation process, whereby each partner was playing their part and integrating their skills in the creation of a 'new product'.

The writing and developing of the learning materials began in 1998 and the delivery stage took place between 2000-2001. In all 28 learners agreed to undertake the courses and were willing to be debriefed following this experience. The learners were all from small and medium-sized manufacturing companies. They were a self-selecting group, responding to information disseminated via government agencies. Learners were interviewed using a interview schedule which included questions on learner's background, responsibilities, previous training pattern and learning style. Informants were asked about their motivation for participating in on-line learning, personal development aims and benefits that they hoped to gain. Their experience of understanding this process of learning was considered, including obtaining permission, difficulties, learning patterns and emotions experienced as they interacted with a computer rather than a human being.

Strengths and weaknesses of virtual learning

As a piece of research the TISCAM/TIME projects were valuable in revealing the strengths and weaknesses in embarking upon the e-learning route. Firstly, it became very apparent that a great deal of background preparation has to be very rigorously carried out to ensure learners receive effective and valuable experience. The technological aspects appeared a priority in the first stance, but in retrospect the research team began to realise that some understanding of learners needs, how best they learn, levels of IT skills and patterns of learning must first take place. In other words learner needs should inform technology and software used and not vice versa.

Estimate of tutor support per learner was also difficult to predict and learner requirements varied greatly. Especially in the early stages each learner requires a great deal of support, both for negotiating the technology and the course content. Ensuring sufficient and fast support response was found to be very resource intensive. Theoretically, the fact that tutors were available at the other side of the email was seen as very positive, but in reality this could be overwhelming for the tutors concerned.

Instructors and students interaction

A weakness in the TISCAM project was the failure to give an adequate level of tutor support to learners. Although it was hoped that learners would experience a process of more or less self-managed learning by entering a virtual classroom, interacting with a community of teachers and learners in order to meet individual or organizational learning and development needs (due to problems with technology and management of the project) this was not fully achieved. But the need for interactive communications, with tutors and with other learners, was highlighted by almost all students. This problem was mitigated somewhat by the fact that each SME had small groups of learners, who supported each other and benefited greatly by discussing problems and ideas during work time. Even though some learners were following different courses, within the same companies, they were sharing the same experience, and problems arouse to which all learner could relate, which contributed to an effective working environment.

Different Models of learning delivery – teleconferencing and website

It was decided that the learning modules would all be designed and developed for full on-line delivery. Working alongside the universities who were responsible for the course content, was an IT company who designed the website and placed the course material on the internet and was in charge of maintenance and changes to the text. Each unit of the course was made up by the core text, case studies, additional articles and materials, exercises and assessments, as well as hyperlinks to live sites, chatrooms for students collaborative work and email to tutors and IT company.

Experience of team teaching

The TISCAM/TIME project was supported by a team of academics. It was important that each partner felt part of the team and able to exploit this relationship to ensure effectiveness of the group. The project was supported by technicians and academics who provided covering authoring guidelines, guidelines for learners, learner support systems, tutor, mentor and facilitator guidelines and the role of Regional Delivery Centres (Oliver 1999, Anderson and Oliver 1999).

Students and instructors use of the Internet for virtual learning

In general the UK learners found that it was easy to start following the on-line courses, but difficult to continue and actually complete them. There were many reasons for this, and as may be expect with an experimental research project, where the technology is being simultaneously developed, some were due to technical 'teething-troubles'. Five specific issues emerged:

- ?? Critical moments – when problems occur with technology and learner is unable to solve
- ?? Seamlessness - ensuring that the technology, media and content work together so that the learner feels that the experience is seamless rather than disjointed
- ?? Support - ensuring that learner feels adequately supported in the learning process both on content and technology
- ?? Language – Is the language used and style adopted 'right' for the learner?
- ?? Fit – does the use of technology and course content fit into the learners broader programme for personal development?

Conclusions/Recommendations

The first thing that comes from the learner experience is that embarking on on-line delivery emphasises the complexity involved in such projects. In particular, it is crucial that training is provided for both tutors and learners to ensure the learners receive effective and valuable experience (background preparation). Failure to engage students in a positive way from the outset can lead to disillusionment, and failure to complete the course. Once the student is engaged, and understands the value and potential for accessing a vast world of information through the use of the Internet, the pathway to successful learning is established.

References

Contact the author for a list of references.

Multicultural Issues in Study Abroad Contexts

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Abstract

The continued growth of international business attests to the fact that businesses need people who can function in other cultures. One of the best ways to be successful abroad is to experience another culture by living and working or studying in that culture. Living abroad usually requires proficiency in the language of the host culture; however, while proficiency is a necessary condition for participating in daily life, it is not sufficient for success. To succeed, guests in other cultures also need a practical knowledge of the implications of their actions in the host culture. Since many people who plan careers in international business travel to other countries to study and learn about multicultural issues, it is vital that they learn about cultural contrasts that may thwart them. This presentation focuses on study abroad programs and the kinds of cultural differences that students may encounter in higher education in other countries.

Introduction

The continued growth of international business attests to the fact that businesses need—and will continue to need—people who know how to function effectively in other cultures. One of the most efficient ways to prepare for success abroad is to experience another culture first-hand by living and working or studying in that culture. Living abroad usually requires proficiency in the language of the host culture; however, while language proficiency is a necessary condition for participating in daily life, it is not sufficient for business, academic, or interpersonal success. To succeed in any of these arenas, guests in other cultures must also have a practical knowledge of the implications of their actions in the cultural milieu in which they are living. Since many young people who plan careers in international business travel to other countries to study and to learn about multicultural issues, it is vital that they become attuned to cultural differences that may thwart the unwary. This study describes an ongoing investigation into the kinds of cultural differences that students in study abroad programs may encounter as they embark upon academic work in cultural settings different from their own.

When people take up temporary residence in another country, it is almost inevitable that they will encounter some misunderstandings as they go about daily life in the host culture. As an example of a cultural contrast, let me relate a situation that I recently encountered. During the spring of 2003, I had the great good fortune to be assigned as a Fulbright Senior Scholar at Comenius University in Bratislava, Slovakia, where I taught Psycholinguistics to a group of students in their fourth year of studies. I met the students every Monday morning and, as I do in the United States, I opened each class by "throwing out" general questions to the students about information that had been presented in the last class. I did this for three reasons: 1) to refocus the students' attention on the topic, 2) to give them an opportunity to ask questions about the last class and 3) to serve as a point of departure for that day's discussion. My expectation was that students would quickly raise their hands so I could call on one of them to answer my question. To my surprise, I had a very hard time persuading the students to answer the questions, which were quite general and easy to answer. Even though their English was excellent, I began to wonder whether or not they had understood the material presented in the previous lesson. I labored on for several weeks trying to pry answers out of the students, then, when I was talking to the dean about another matter, I happened to mention my frustration in getting the students to participate. The dean looked at me with a puzzled expression, and then said that if he were a student in that class, he would feel as if I were examining him, so he would hesitate to take a chance on answering incorrectly! I was dumbfounded at this explanation, but quickly realized that I had been making a cultural mistake! Had I realized that I was expected to give a formal lecture about the day's topic and not conduct the class as a discussion, as I do in the United States, I would have known that such questions were not part of the schema for classroom interaction.

This story, which describes a misunderstanding in educational culture, points up the need to prepare students for similar cultural encounters. However, in preparing students for higher education in another country, most study abroad programs focus almost exclusively on making sure that prospective students have the requisite level of language proficiency to participate successfully in their courses. In fact, study abroad opportunities are often made available only to students who have attained at least an intermediate level of language proficiency [4]. It is thought that students with lower proficiencies will not derive sufficient benefit from an experience abroad that is focused on a topic other than the language, itself. While home institutions understand that students must have this language prerequisite, they generally assume that the educational culture in the host country will be similar to that in the native culture. Thus, students with at least intermediate proficiency in the target language are expected to have few problems in courses taught through the medium of that language. As my story indicates, this is rarely the case. Students, who embark on coursework in the host culture equipped only with their own cultural expectations of educational practices, will be baffled, or worse, by their interactions with professors and peers. If they are to maximize their experiences, these people must understand what is expected of them *in their role as students in the target culture*. This includes becoming familiar with information about such topics as interacting effectively with peers and instructors, presenting written work in an appropriate way, and taking tests, which may be given in unexpected formats.

Focus of the Study

When we compare educational systems across cultures, it is natural to ask questions that are large in scope, such as:

- Who is educated? Everyone? Or just a subset of the population?
- What kinds of things are taught? For example, is practical knowledge valued over the study of theory?
- How is education accomplished? Do students partake in formal schooling? Or are skills learned via apprenticeships?
- Should new information be memorized? Or should it be assimilated and used creatively to solve problems?

Important and interesting as these questions may be, answering them is beyond the scope of the present study. The current investigation focuses on identifying areas where international students may not know the "rules of the game" — in this case the rules that govern interaction between students and their instructors and students and their classmates. If students don't know these rules, they are unable to interact successfully with their professors and peers and they are put at a great academic disadvantage. This may result in their study abroad experience being less rewarding than expected or in their terminating the experience early. Furnham and Bochner [6] characterize international students as "sojourners," that is, people who spend an extended period of time in another culture, who are in need of culture learning (learning the afore-mentioned rules) to navigate situations that they find difficult. Interactions in educational settings often constitute such difficult situations; however, discovering information about what to do or avoid doing is not always easy. Current information about contrasts in classroom "rules" across cultures has been largely confined to anecdotal references embedded in articles on other topics [3, 7, 8, 9, 10, 11] and has not been organized and presented in any systematic way. That this information is not readily available poses a problem for culture-learners (and those who would train them).

The Study

The present study is designed to gather and bring together in a systematic way information about areas where cultures can contrast in educational settings. To do this, this study poses the following research questions: Where do contrasts in academic culture manifest themselves? What are the characteristics of these contrasts? It was expected that generalizations would emerge in several areas: In-class instructor-student interactions and student-student interactions; out-of-class instructor-student interactions and student-student interactions; cultural expectations for people in the role of student; cultural expectations for people in the role of instructor, and expected formats for tests and written work.

In order to gather data to answer these research questions, an approach based on ethnographic methods (interviews, observation, and participant-observation) was adopted [11]. This approach, which draws on information gathered from different sources, allows triangulated information to be analyzed and made accessible to student culture-learners and to those charged with preparing them for international study. This approach will also serve to produce a grounded theory of classroom culture in which generalizations that emerge when the data are analyzed can be used not only to train student sojourners but also to provide a theoretical framework for future research [11].

Relevant data were gathered from many different sources: interviews with international students in the US, interviews with North American professors teaching international students; interviews with North American students studying abroad, observation of colleagues who were working with international students or in international contexts, and finally, observations made by the researcher during a career of working with English as a Second Language (ESL) students in the US and of teaching and learning in countries outside the US.

The interviews with international students were structured and touched on topics such as contrasts between appropriate student behavior in the US and in the student's home culture, contrasts between appropriate professor behavior in the US and in the home culture, contrasts in expectations for homework, office hours, examinations, etc. Finally, in the hope of eliciting contrasts in educational culture that were not apparent to the researcher, each interview included an opportunity for the student to offer advice to someone from his/her country who was planning to come to the US to study.

Interviews with North American colleagues were less structured, but focused largely on problems that they had encountered in dealing with international students. Some of the information elicited from these instructors concerned the students' language ability; however, since this was not cultural information, it was not used in the present analysis. In these conversations, inappropriate behavior, not contrasts between home and host culture, was the topic of discussion. Many of the instructors' perceptions of inappropriate behavior had to do with student's academic work and their demeanor in and out of the classroom.

Similar to the interviews with international students in the US, the interviews with US students living abroad were also designed to elicit information about student and professor behavior that contrasted with their experiences in the US.

Observations of classrooms were made in the US and abroad. During observations in the US, the researcher endeavored to record typical classroom behavior for teachers and students. Observations made abroad shed light on contrasts between US classroom culture and classroom culture in other countries.

Finally, observations made by the researcher during almost thirty years of working with ESL students in the US and of living and working abroad were included in the data pool.

After the data were collected, they were pooled and analyzed. Items that appeared only once in the data were deemed idiosyncratic and not included in the final analysis. Items that appeared twice or more were noted and grouped into areas of commonality. Several such areas emerged from this analysis: Characteristics of students, characteristics of classes, characteristics of interactions within the classroom, instructor behavior in the classroom, student behavior in the classroom, characteristics of evaluation procedures, instructor behavior outside the classroom, student behavior outside the classroom, cultural expectations for instructors, cultural expectations for students, instructor-student relationships, and student-student relationships. Each category (elaborated below) is characterized by several features that were drawn from the data. Sometimes these features are binary; but, most often, they are best described as continua, with appropriate values for different cultures occupying different points on a particular continuum. The following descriptions of the categories are followed by the characteristic features that emerged from this set of data.

Results

The following categories emerged from an analysis of the data gathered in the interviews and observations described above.

Characteristics of Students

In this category, factors such as age, sex, and social status were noted. In many countries, university students are all of traditional age; people who have followed another career path do not return to the university for coursework later in life. In other countries, people continue to take university courses throughout their lives — sometimes to change careers and sometimes for personal edification. Some students expressed surprise that older students attended the same classes as traditional age students did, creating a student group of widely varying ages. Similarly, in many countries, men and women study together in the same classrooms and may have teachers of either sex; however, in other countries, classes are composed of the same sex — men and women do not study together or have teachers of the opposite sex. Some students reported that it required an adjustment to interact with the opposite sex in the classroom. Finally, in many countries, education is available only to the social or intellectual elite; the latter must demonstrate their status by passing tests at various stages of their lives. Still others educate (or bar from higher education) members of a particular ethnicity or religion.

Age: traditional age < — > all ages

Sex: both sexes/one or the other

Other Demographic Characteristics: elite group (social, ethnic, religious, intellectual, etc.) < — > all inclusive group (regardless of social class, ethnicity, religion, test scores, etc.)

Characteristics of Classes

Typical class size is a variable that can surprise international students. Students from countries where classes are usually large may find themselves put "on the spot" in classes that are smaller than they are used to. On the other hand, students who are used to small classes and a great deal of interaction with the instructor may find themselves "lost in the crowd" in larger classes. These feelings can be unsettling and cause students' academic work to suffer.

The degree of formality that is appropriate in the classroom can also fluctuate from culture to culture and may be a source of problems for international students. In many cultures, the classroom is a very formal place where students and instructors[i] dress in conservative clothing (sometimes uniforms) and comport themselves in formal ways. Instructors in these cultures are generally addressed using titles and any interaction between the instructor and the student is characterized by use of formal language. Many of the international students interviewed for this study expressed surprise at the informality of their North American classrooms. When students from less formal cultures enroll in classes in formal cultures, they are likely to commit errors that will cause them to be seen as lacking proper manners.

Size: large (over 50) < — > small (under 50)

Formality: very formal < — > informal

Clothing: very formal clothing (sometimes a uniform) is worn by teachers and students < — > informal

Terms of Address (student to instructors): title only < — > first name (Possibilities: title only, title + last name; last name, title + first name; first name [and patronymic])

Terms of Address (instructor to students): no name < — > first name (Possibilities: the equivalent of English "you"; title + last name; last name only; title + first name; first name only)

Pronoun used in address (in languages that distinguish between formal and informal "you") (student to instructor): (Possibilities: formal "you" + honorific; formal "you"; informal "you")

Pronoun used in address (in languages that distinguish between formal and informal "you") (instructor to student): (possibilities: formal "you"/ informal "you")

Self-reference (in languages that have several different forms for English "I") (student to instructor): neutral < — >self-deprecating

Posture: very formal < — > very informal

Students stand when the instructor enters the classroom. < — > Students remain seated when the instructor enters the classroom.

Students sit with their feet on the floor. < — > Students may assume very informal positions, including putting their feet on unoccupied chairs.

Characteristics of Interactions in the Classroom

Interaction in the classroom can be characterized by the type of exchanges that takes place between the instructor and the students. In some cultures, teachers are expected to present formal lectures that do not admit of interruptions from the students. In other cultures, students may interrupt the instructor to ask questions or to make comments — even comments that challenge what the instructor is saying. If students who are used to asking questions and disagreeing with the instructor find themselves in a classroom where their questions are unwelcome, they put themselves at a disadvantage.

In classes where discussion is encouraged, the rules for participation vary. Sometimes the instructor asks a general question to stimulate talk about a particular topic. This, in itself, may be difficult for students who are expecting lectures and not discussions. In some classrooms, students are expected to signal, usually by raising their hands, that they would like to talk. In these cases, it is the teacher who controls who may speak and when. In these cultures, one person "has the floor" at a time and no one else is supposed to be talking at the same time. In other cultures, discussions are freewheeling with no signals for a desire to comment, which can result in many students talking at the same time. International students in the US, who were used to participating in discussions without waiting to be recognized, expressed embarrassment when they were asked to wait their turn.

Another area in which classroom interaction can differ is in the use of group activities. In many cultures, instructors are expected to be the dominant figures during class, while group problem-solving activities may be the focus in many classes in other cultures. If students are not used to group work, they are unlikely to know the "rules" of participation and be ostracized by their host culture peers.

Students are free to ask questions during the lecture/presentation. < — > Students shouldn't ask questions, they should speak only when spoken to by the instructor.

Method of conducting the class: lecture < — > discussion

In discussion classrooms

Instructor asks questions and expects students to volunteer to answer. Yes/No

Students signal that they want to talk by raising their hands. < — > Students talk only when they have something to say.

Instructor controls discussion by calling on students one at a time. < — > Students answer all at once.

Students express strong opinions and argue with each other. < — > Students participate, but don't express strong opinions.

Students may openly disagree with what the instructor is saying. < — > Students are not expected to disagree with the instructor.

There is group work during the class. < — > There is no group work during the class.

Instructor Behavior in the Classroom

The behavior of instructors can also be a source of confusion for international students. For example, in some cultures, the instructor takes roll; in others, class attendance is not mandatory. One international student from a culture where attendance is not mandatory failed all his courses at a North American university because he came to class only on the first day. In some cultures, instructors close (and occasionally lock) their classroom doors once the class has begun; in others, classroom doors remain open during the class, allowing late-arriving students to enter without fanfare.

In some cultures, the instructor assigns readings in a text book or other source; in others, students are expected to obtain all the information they need from the lecture or presentation during the class. Several students interviewed for this study expressed surprise at the long reading assignments they received in North American universities.

The instructor may make himself/herself available to the students after the class is over, or there may be very little interaction between the instructor and the students.

If international students whose educational culture is at one end of these continua encounter instructors from the other end, the potential exists for many misunderstandings that are potentially damaging to the student's academic progress to occur.

Attendance: Instructor takes roll. < — > Attendance is not compulsory.

Admittance to class:

Instructor closes door when class begins. < — > Door is usually left open.

People who come after the door is closed must knock to be admitted by the instructor.

< — > People can enter quietly without the instructor's permission or notice.

Instructor provides a syllabus for the class. < — > No syllabus is provided or expected.

Instructor does not assign a text or reading outside of class; students are expected to find the information they need to learn in the lecture/presentation. < — > Instructor uses a text (or other source) and makes assignments that students are expected to read before coming to class.

Instructor's lectures/presentations show continuity with preceding classes. < — > Lectures/presentations are self-contained and are not dependent on what preceded them or what will follow.

Academic work outside of class:

Instructor assigns homework (reading and/or writing). < — > No homework is given.

Instructor assumes that students have read and prepared for class. < — > No assumptions about students' prior familiarity with the material are made.

Instructor stops to talk to students after the class is over. < — > Instructor leaves the classroom before the students and does not interact with them.

Instructor may eat or drink during the lecture/presentation. < — > Instructor may not eat or drink during the lecture/presentation.

Student behavior in the Classroom

Appropriate behavior for students may be similarly elusive for international students. In some cultures, students are expected to take a very passive role in the classroom, while in others; students are expected to participate actively in the class by coming to class prepared (having read the homework assignment), asking questions, and taking part in group activities. This can be a difficult transition for international students from cultures in which the role for students is to be silent. In addition, there are various classroom etiquette rules that govern appropriate student behavior toward the instructor and the other students. For example, waiting until the instructor has left the classroom before leaving.

Students are willing to volunteer to answer the questions the instructor asks to begin the discussion. < — > Students are unwilling to answer the questions the instructor asks to begin the discussion.

Students are silent when the instructor or another student is talking. < — > Students feel free to carry on private conversations while the instructor or another student is talking.

Students may ask questions during the presentation/lecture. < — > Students may speak only when spoken to.

Students come to class having done the assigned homework. < — > Students come to class without having done the assigned homework.

Students are not supposed to laugh during class. < — > Students may laugh during class when it is appropriate.

Students who arrive late to class must ask permission to enter. < — > Students who arrive late to class should enter as quietly as possible.

Students enter and leave the classroom without asking permission. < — > Students remain in the classroom during the entire class.

If the hour for the end of class has passed and the instructor is still teaching, students: begin to pack up their things in preparation for leaving in order to send a signal to the instructor.

< — > wait until the instructor realizes that the class is running overtime and don't try to signal that the hour is late.

Students wait for the instructor to leave before they leave. < — > Students leave when the class is over.

Characteristics of Evaluation Procedure

Testing is ubiquitous, but the format in which it is administered differs from culture to culture and can confuse international students. Students who are not accustomed to taking tests when they have not prepared for them may be unpleasantly surprised when they discover that they must take the test on the date the instructor designates — and that they have only one opportunity to pass. Students who are used to taking oral examinations may be discomfited if they have to write their answers — and *vice versa*. Students from some cultures may not understand what to do with objective-format examinations, for example, multiple choice questions, especially those that require students to use machine-scorable answer sheets. In addition, sanctions for the use of inappropriate materials or for communicating with other students during the examination may differ from the student's home culture. Violating an academic integrity convention can have disastrous effects on a student's academic progress and, in some cases, may result in his/her dismissal from the university.

Students take tests whether they are prepared or not. < — > Students are not required to take tests for which they feel unprepared.

Instructors give tests and quizzes during the term in addition to the final examination. < — > Instructors give only a final examination.

Instructors leave students alone while they are taking a test. < — > Instructors do not leave students alone while they are taking a test.

Students surreptitiously use materials (books and notes) that are forbidden during a test. < — > Students do not use forbidden materials during a test.

Students communicate with one another during a test. < — > Students do not communicate with one another during a test.

Examinations are oral. < — > Examinations are written.

Examination questions require students to write short essays. < — > Examination questions require students to respond with short or one-word answers.

Examinations are given in multiple choice format. < — > Examinations require students to supply answers.

Instructors use answer sheets that can be machine-scored. < — > Instructors do not use machine-scorable answer sheets.

Instructors require students to use examination booklets. < — > Instructors do not require students to use examination booklets.

Students write their names on the top of their examination papers before they begin to work. < — > Students write their names at the end of their examinations after they have finished.

Students offer their instructors gifts, especially when they need a recommendation or a good grade. < — > Students don't offer their instructors gifts.

Instructor Behavior outside the Classroom

An instructor's behavior out of the classroom may also cause confusion for international students. In some cultures, instructors make themselves available outside of class hours; in others, they do not concern themselves with students as individuals. It is to be expected that students from cultures where there is frequent interaction with instructors outside the classroom may make mistakes when placed in a culture where such contact is not the norm.

Office Hours:

Instructors hold office hours. < — > Instructors don't hold office hours.

Students assume that they may visit instructors during office hours. < — > When an instructor is in his/her office, he/she is too busy to talk to students.

Instructors are available for students when they are not in their offices, for example, when they are walking across campus. < — > Instructors are available only during their office hours.

Students need an appointment to talk to the instructor. < — > The instructor is available during office hours without appointments.

Instructors are interested in students' progress. < — > Instructors are indifferent to students' progress.

Instructors prepare materials, like review questions, to help students understand. < — > Instructors do not prepare materials to help students understand.

Instructors are flexible and understanding of student's problems with deadlines. < — > Instructors are not willing to make concessions if students have problems meeting deadlines.

Instructors accept gifts from students. < — > Instructors do not accept gifts from students.

Student Behavior outside the Classroom

Similarly, expectations for student behavior vary from culture to culture. Often students are expected to be conscientious and do their out-of-class assignments individually; other times, students share their work with others and their assignments do not reflect individual effort. This can be confusing for international students who may be asked by other students to share work in what may seem an inappropriate way. In other cultures, inappropriate sharing of work may result in loss of credit for having "cheated."

Students share their written homework assignments with each other, so that only one or two actually do the work. < — > Students do their own homework assignments.

Students form study groups among themselves. < — > Students work by themselves.

Cultural Expectations for Instructors

Each culture has expectations for people who fill the role of instructor; for example, they may be seen as being responsible for their students' success or even as the students' surrogate parent and expected to offer advice about life in general. If international students expect something from their instructors that is not part of the host cultural expectation, they will be confused.

Instructors are responsible for the success of their students. < — > Students are responsible for their own success.

Instructors are seen as dispensers of knowledge. < — > Instructors are seen as resources to help students learn.

Instructors are expected to retest students who fail. < — > Instructors give one test and students who fail do not receive another chance.

Instructors are to assume an almost parental role in the students' lives. < — > Instructors do not offer guidance in any arena other than the students' education.

Cultural Expectations for Students

Similarly, each culture has expectations for people who fill the role of university students. For example, they may be expected to know how to write a paper or take an oral test. In many cultures, there is an expectation that students will not use the work of other people without documentation; however, this idea (called *plagiarism* in English) is by no means universal. When students for whom this is not a cultural expectation use others' ideas without documentation, they may be strongly censured in the host culture.

University students should know how to write academic papers. < — > University students have no need to write academic papers.

Students should use citations when they use the work of others in their writing. < — > Students may freely borrow from the work of others without documenting the source.

Students who do not use citations when they use the work of others in their writing are subject to academic censure. < — > No penalties are connected with using others' work without documenting the source.

Instructor-Student Relationships

The relationship between instructors and students also varies from culture to culture. Sometimes instructors are quite friendly with students and sometimes, they are distant. Instructors may see themselves as resources for their students, or they may see themselves as dispensers of knowledge. These values, if they are not similar to those in the home culture, may cause problems for student sojourners

Instructors are friendly with students. < — > There is a great social distance between instructors and students.

Instructors interact with students frequently on an informal basis. < — > Instructors do not interact with students outside of class and office hours.

Instructors see themselves as resources for students. < — > Instructors see themselves as experts in the field who present knowledge for the students' edification.

Students are very apologetic or obsequious in their relationship with the instructor. < — > A relationship of mutual respect exists between the instructor and the students

Student-Student Relationships

The degree of friendliness among students in the host culture may also confuse international students. Students may be friendlier with each other than the international student expects, or conversely, not as friendly as in the home culture. An international student who expects a close relationship with his/her peers may be disappointed.

Students form a cohesive group and help each other succeed. < — > Students are cordial, but do not collaborate.

Each student is part of a group that is following the same program and all students in the group are enrolled in the same classes. < — > Each student is taking a different array of classes.

Applications of these results

The insights into cultural contrasts that emerge from this set of data can be used to inform the preparation of students who plan to spend a semester or longer in another culture. While it does not give specific guidelines about particular cultures, it provides a framework to guide attempts to compare and contrast two different cultures.

Ideally, using this framework would help those charged with preparing students for an international experience to compare the home culture with the host culture. Such an analysis would help determine how different classroom experiences in the host culture are likely to be for the students. If the two cultures differ greatly on the continua described in the framework, it is likely that students will have more trouble negotiating the educational process than if the cultures are fairly similar. Furnham and Bochner [5], using the Culture-Distance Index devised by Babiker, *et al*. [2], found that the difficulties faced by student sojourners were directly related to the differences between the home and the host cultures. If prospective international students can learn about potential cultural "hot spots" before they encounter them, they might learn to navigate the new culture more efficiently.

Care should be taken, however, not to ignore aspects of the home or host culture that does not fit into the framework as it is presently conceived. It should be remembered that this is a work-in-progress and that new areas of commonality and new features are certain to manifest themselves as the framework is used and more data are gathered. Similarly, users of the framework should not perform superhuman feats to find something in the host culture that can be considered relevant to every item on the framework — it may be that some aspects of educational culture mentioned in the framework are not salient in the culture under consideration.

While the present investigation does not provide specific guidelines for a particular culture, prospective international students may do well to follow the principles of navigating a new culture set forth by Nancy Adler [1]. Adler makes four general recommendations: 1) Be aware that you don't know the rules of the culture. Don't be afraid to ask questions and listen; also, remember that behavior that may seem strange to you makes sense to the people who are doing it. Try to see reality from their perspective and you will learn something valuable about the host culture. 2) Assume that things are different until you have reason to assume that things are "just like home." This stance will force you to pay attention and listen to what is being said and not project home culture rules onto host culture situations. 3) Make guesses about what you're experiencing; don't jump to conclusions quickly. You may see that there are several explanations for behavior that is mysterious to you and it will take time to discover which is the appropriate one. 4) Find something in the host culture (for example, a sport) that you enjoy doing and participate. These recommendations constitute sound advice for a successful sojourn.

Implications for Future Studies

The framework that emerged from this investigation into contrasts in education cultures can also be used as a tool for analyzing additional data from future interviews and observations. As more and more contrasts are elicited from international students and the instructors who teach them, new commonalities are expected to emerge that will augment this framework. It should be remembered, however, that this study is only a beginning and that the framework that emerged is subject to change when new data warrant it. Indeed, the framework itself may be altered to accommodate new data more efficiently. Similarly, the characteristic features of each category in the framework will be elaborated upon and refined as additional data become available. This will give us a better picture of what international students may face when they embark on an educational encounter in another culture.

Conclusion

This investigation, in which contrasts in educational culture have been studied, constitutes a beginning of the systematic investigation of this topic of culture. The results have applications for the preparation of international students and implications for future investigations into classroom culture. As more and more data are gathered and analyzed, it is expected that our insights into this fascinating topic will become sharper and that these new insights will inform our training of potential international students.

In our shrinking world, it is becoming more and more important for students whose goal is a career in international business to become familiar with the culture in which they will be studying.

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End Notes

[i] The word "instructor" has been used throughout these descriptions because the word "professor" often has different connotations in different cultures. For example, in the US every university level instructor can be called "professor;" while in other countries there are only a few "professors" in each department and many "lecturers" who are equivalent to "professors" in the North American sense. In working with international students, it seemed that "instructor" was a more neutral term than "professor". Similarly, the word "teacher" was avoided as it often carries the connotation of high school teacher.

Managerial Skills and Organizational Climate in Educational Services Sector

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Abstract

The business environment conditions are likely to witness more volatility in the coming years. To balance the local and global challenges, the economies are relying more on the service sector throughout the globe including India. The educational service comes at the core while setting the pace for the rest of the sector. Education services such as intangible and evaluation of the same are normally obtained by judging the content and the delivery system where precise standardization is much difficult. Competitive advantage and professional excellence in turn fundamentally depends upon the skills of the educational manager/administrator and the prevailing climate within. The findings of the study reveal that in this service sector problems are largely solved by using cognition and logic, and conflicts are handled with a positive bent of mind by collaboration style. The climate has been found communicative enough with realistic performance standards, a well-defined reward system, democratic structure and participative goal setting; making it commitment driven. The interaction between the two is more significant on collective basis instead of individual basis where the mediating variables play a dominant role in the performance.

The Backdrop

The business environment conditions are likely to witness more volatility in the coming years. To balance the local and global challenges the economies are relying more on the service sector. Even the fastest growing segment of the US economy and other developed nations are dominated by services. In the Indian economy today the domination of the sector can be testified from the fact where it contributes more than half of our national income. Service is the fastest growing sector witnessing an annual growth of 8% per year. In such a situation of precariousness, gaining competitive advantage and professional excellence will be the major guiding forces in all type of organizations including the services sector. Within the services sector educational services comes at the core while setting the pace for rest of the sector. Education as a service can be said to be fulfilling the need for learning, acquiring knowledge – providing an intangible benefit (increment in knowledge, aptitude, professional expertise, skills) procured with the help of a tangible (infrastructure) and intangible (faculty expertise and learning) means, where the buyer of service does not get any ownership (Ravi Shanker, 2002). Education, like most 'pure' services, is intangible and evaluation of the same where it is normally obtained by judging service content and the service delivery system and where precise standardization is much difficult as it procured as a shopping service or specialty service. More so whether a service is bought for instrumental motive (i.e. as a means to an end) or for an expressive motive (as an end in itself) may provide useful framework for service designers (Swan and Pruden, 1977). Irrespective of any design or framework, competitive advantage and professional excellence fundamentally depends upon the skills of the educational manager/administrator and the climate prevailing within the organization. This continuum encouraged the authors to carry out the present research. The ensuing sections bring out the conceptual framework of managerial skills and organizational climate, scope and methodology, and results of the study.

The Thematic Framework

Conceptually the term 'skill' means the ability to complete the specific task successfully. It is an acquired or learned ability to translate knowledge into performance. It is important to remember that the individuals are not universally competent. Key component of ability include task-relevant education (formal and informal training that facilitates the successful completion of the specific task); task-relevant experience (prior work experience that contributes to the successful completion of the task); and task-relevant skills (proficiencies that enhance the successful completion of the task) (Hersey and Blanchard, 1995). Here the skill occupies a prime seat as if the individual has an ability problem, solutions may include specific training and coaching; but to develop skills the individual requires an attitude which can be learned overnight. An educational administrator has to analyze the performance of his fellow colleagues, and has to confirm whether they have the knowledge, skills, and experience for task performance. This very analysis requires an administrator to be full of many managerial skills which can broadly be classified as skills according to levels of management i.e. technical skills, human and conceptual skills, and skills according to the managerial functions i.e. planning, organizing, leading, and controlling. Within this gamut of two categories, there are certain skills which are more important for an educational manager and that is why in the present study only three managerial skills viz. problem solving styles, locus of control and conflict handling styles have been studied.

Climate for any organization can be equated with personality of a person. As every human being has a unique personality, it is the same way with every organization having a distinctive climate. Organizational climate is a set of attributes specific to a particular organization that may be induced from the way that organization deals with its members and its environment. For the individual members within the organization, climate takes the form of a set of attitudes and expectancies which describe the organization in terms of both static characteristics (such as degree of autonomy) and behavior outcome and outcome-outcome contingencies (John P. Campbell, 1970).

An organization survives and thrives due to prevailing climate. When employees of the organization are well aware and follow the rights, rituals, and policies of the organization they are bound to develop a sense of belongingness and become better performers. The climate of the organization is generally reflected in the attitude of seniors towards their subordinates and the consequent perception of rightness among the subordinates. In turn climate of the organization is also affected by almost everything that occurs in the organization making it a dynamic system concept. In an organization people come from heterogeneous streams with varying personal cultures, traditions, thinking and methods of working. It is often felt that one individual may influence the climate little bit but the group of individuals have a multiplier effect and absorption of these diverse individual sub-cultures may affect the prevailing climate. The same way incoming employees may also have to change their traditions, thinking and work methods to be a better fit in the organization. Thus the climate of an organization is developed and communicated through the organizational behavior system. A renowned behavioral scientist, Richard M. Hodgetts (1991) has classified organizational climate into two major categories and compared the organizational climate with an iceberg whose one part being on the surface is visible whereas the other being under the water is not visible. The visible part that can be measured mainly include structure of hierarchy, goals and objectives of the organization, performance standards and evaluation process, technological state of operation etc. The invisible and unquantifiable comprise of subjective areas like supportiveness, employees' feelings and attitudes, values, morals, personal and social interaction with peers, subordinates and seniors, and a sense of job satisfaction. Both of these categories have been shown as under in the form of an iceberg. Thus organizational climate as such is not a unified concept rather a mix of many more related activities. The important components that collectively represent the climate of an organization mainly include members' orientation, interpersonal relationships, individual autonomy and freedom, degree of control, type of structure, management orientation/style, reward system, communication, conflict management, degree of trust and influence, and risk taking environment of the organization. Some of these components are the overt factors and measurable while the others are covert factors and cannot be quantified. Based upon the responses of the employees the organization can go for a change in the climate if desired so that the organization can boast of having the best organizational climate amongst its competitors.

Literature Review

Different behavioral thinkers have given their opinion on different aspects of the subject. Though there was not a single study in direct consonance of the present topic yet these were of definite help for further exploration of the area and a very select from the related studies have been presented in the present part of the study. Katz (1974) has viewed that successful managers are indeed electric in that they must possess and be skilled in technical, human and conceptual areas of organizational life. Technical knowledge and skills include understanding and being proficient in using a specific activity and technique and usually required more at the operative level. Conceptual knowledge and skills include having the ability to visualize the enterprise as a whole, to see the 'big picture' to envision all the functions involved in a given situation. To conceptualize requires imagination, broad knowledge, and mental capacity to conceive abstract ideas. It is this conceptual requirement that enables an executive to recognize the interrelationships and relative value of the various factors intertwined in a managerial problem and hence required more at the top level managerial position. Human skills as the name suggests include the ability to work with others and to win cooperation from people in the work group. The managers with human knowledge and skills understand and recognize what adjustments or changes in these views might be made as a result of working with associates, and required everywhere irrespective of the managerial level.

Anand Sarup (1997) in his thought provoking article has raised certain issues for educational planners. The author has stressed that majority people take education as a means essentially of imparting, knowledge and skills mainly for enhancing the employability of participants. At the same time the factors like global competition, balance of trade and inflow of capital and technology are fast becoming the determinants of economic performance as well as work opportunities. This all situation can be observed like a crystal ball as characterized by an increasingly rapid rate of change. By the time one adjusts to a new reality, it is overtaken by a still newer reality. Therefore the administrators of the future need to be multi-skill personalities. In this multi-skilled personalities wake they have to be jack of all managerial skills but they have to be master in 'change management skill' particularly.

Satpathy (2000) has suggested a distinct type of managerial skill development profile for the future managers. In his thought provoking article has given Vedic Model of skill development. The findings are in relation to knowledge industry which in its broadest sense is an industry wherein the employees can decide in their own as to what is wrong and what is right using their knowledge base, and for that matter education is a much stronger knowledge industry. The author is of the opinion that in the coming years India will become an economic superpower mainly due to its vast intellectual resource and great heritage. The creativity of Indians will make India self-reliant and economically sound. Therefore, importance of Indian philosophy to build up future organizations to be of world class is highly relevant. If lessons on sound management from *Bhagawad Geeta* are incorporated in the management discipline the skills can be much performing and rewarding for Indian managers.

Bajaj (2001) has highlighted the paradigm shift in management of colleges and stressed that due to all around changing environment, education cannot be an exception to such changes. In such a situation of turbulence the principal has a definite role in running the college and that he is the catalyst in pushing the academic ideals for which the college stands for. In the context of challenges of change there has to be a paradigm shift in his style of leadership and functioning. He is an interactive institution as such and the undisputed kingpin of the system who has to make use of all available assets and technological inputs in the institution under his control and stay transparent, committed, and unidirectional in managing the college. He has to combine vision with commonality, dissolve untouchability syndrome of elite and offer new ethos based on interactive freedom and sharing of ideas in the spirit of democracy. The principal has to be alive to the needs of the students and teachers through a participatory mode of management while also ensuring maintenance of quality and standards. That is how through the new skills of the principal the institution can answer the social responsibility call and change this period of transition into an era of fulfillment and turn out students who are confident to face the world.

Young (1976) attempted to assess the actual and ideal social climate of an undergraduate social science class for educator, and also to utilize the information to structure a subsequent class on the same topic. It was hypothesized that a classroom climate more closely approaching an 'ideal' one would facilitate better course appreciation, involvement, and attendance. Modifications in the course of social climate as suggested by 'Class A' markedly improved the social climate of ‘Class B’ as reported by class members. Improved congruence between real and ideal climates was linked to significantly greater appreciation of class functioning, class content, overall course appreciation, and greater class attendance. As students reported similar amount of task orientation in each class, it was argued that the class room social climate may contribute an independent and malleable feature of the classroom setting which an instructor can use to his/her advantage.

Tripathi (1980) in her doctoral research work has studied organizational climate and teachers attitudes. The study discovered that majority institutions fall in closed range climate and private institutes emphasize more on production as compared to government institutions. Attitudinal means of the teachers of closed climate institutions do not differ significantly from teachers of the institutions paternal climate on most of the dimensions of teacher attitudes. Under controlled climate, factor of ‘intimacy’ correlates significantly positively with teacher-attitude towards ‘classroom teaching’, and familiar climate factor ‘disengagement’ shows significant negative relationship with attitudinal factor of ‘classroom teaching’. Under paternal climate there exists highly significant negative relationship between climate dimension of ‘hindrance’ and attitude towards ‘child-centered practices’, ‘educational process’ and ‘pupils’.

Srivastava (2001) conducted a study to explore the strength of organizational culture and its relationship with organizational performance, perceived effectiveness and success among managers. The sample for the study consisted of one hundred and fifty executives from six private sector organizations. The study measured the strength of culture, perceived effectiveness, and success among managers using a structured interview comprising of some objective indicators for performance, pay, and promotions. The study has revealed a positive correlation between organizational culture, organizational performance, individual effectiveness, and success. Organizations having a strong culture performed better as compared to organizations with a weak culture. The study also brought out significant differences in the perception of role incumbents across hierarchy for all the variables. The results suggest that the culture of the organization has its effect on organizational and individual performance. Top management should endeavor to inculcate core values and beliefs among employees by adopting certain organizational practices resulting in better individual and organizational performance and make sure that these are widely shared and upheld by its members.

Shivakumar (2002) has attempted to understand the concept of change, organizational culture, organizational development interventions vis-à-vis the rational for organizational development interventions, to implement and sustain a culture of change, with emphasis on educational institutions. The author is of the view that in this era of change uncertainty seems to be the order of the day. In order to survive the organizations are trying to implement radical transformational changes and educational institutions are not exception to it. If any educational institution wishes to make a mark and create a name for itself, it will have to adopt the universal formula of innovation, technological development, and customer orientation. To have a culture of performance, the educational institutions are bound to adopt modern techniques of organizational development in the form of Sensitivity Training, Team Building, Survey Feedback, Grid Training and Management by Objectives.

Objectives and Methodology

Academic institutions all over the world have been established to provide societal development in respect of knowledge and brainpower enhancement of the people. These institutions are supposed to be centers of thinking, learning, and academic training to contribute significantly to the refinement of perception and cultivation of scientific temper. Needless to say that even in the turbulent years of transition, educational institutions are still endeavoring to provide high talent manpower for economic and industrial development, scholarship and research. This significant role of academic institutions had been in practice since the early civilization of human race as in the ancient times, the countries, which were supposed to be culturally, socially, and economically developed, used to be guided by their academic stalwarts and academic institutions. These institutions used to provide thinkers and selfless advisors too many rulers and even dynasties, and here the role of institution head was considered to be ultimate.

The academic environment of the day has become more dynamic as never before in the context of information explosion and as a consequence of expansion of facilities at different levels and on account of its contextual relevance, more so when it has to respond to global competition. On one hand the academic institutions have to encourage academic citizenship with focus on human resource development, while on the other they have to cope with the challenges such as the urge for excellence, better performance, up-gradation of skills, accessibility with mass education, IT revolution, increasing accessibility, resource crunch, teachers' empowerment, activism appraisal, research and consultancy, autonomy and accountability, commercialization and student support services, bureaucratic interferences, undue interferences of uninformed managements in academic activities, and mounting expectations from all interest groups. This type of environment has created multifarious challenges for the institution heads and calls for multi-managerial skills to cope up with the challenges. As an administrator, a college principal has to interact with people of diverse backgrounds with different positions on one pretext or the other, and it is here where the skills of the principal can create a difference.

Gone are the days when the college principals could work in an autocratic manner as today they have to work in the context of a sweeping awareness of rights without any corresponding enforcement of discipline, duties and other obligations and hence have to be more careful and democratic. From the extensive review of literature though not presented in full here the researchers could not trace even a single study which is directly inconsonance with the title of the present investigation as none of the studies reveal the Managerial skills required for effective educational administrators, organizational climate prevailing and desired in the educational service sector and interaction of managerial skills with organizational climate. Thus, there exists a considerable gap on this aspect and the need for research was felt fulfilling the above mentioned variance and that too in the fast changing academic environment. It is believed that the present research will address the abovementioned areas and will benefit the educational managers to frame the plans and policies for the present incumbents and prospective administrators to enable them to cope up with the changing environment, apart from generating and strengthening a new field of knowledge. The present investigation has been carried out to study the problem solving styles, the conflict handling styles, and locus of control among educational administrators The type of organisational climate prevailing and interaction of the same with the above mentioned skills has also been examined. The study falls in descriptive-cum-exploratory research design and makes extensive use of primary data. The primary data has been gathered with the help of a well-compiled questionnaire based upon four different scales developed by various researchers. The sample size has been curtailed to one hundred educational administrators working as principal in different colleges of Haryana state, by applying convenience sampling technique. The data so collected has been analyzed with the help of need based statistical techniques encompassing mean score, standard deviation, $?^2$ test and F-test (ANOVA), and findings of the same have been presented henceforth.

Findings on Managerial Skills

Change is the normal, natural and inevitable phenomenon in every organization and educational institutions as such cannot be exception to it. Administrators of this competitive and demanding century have a job to do which is considerably different from their predecessors. The role as a college principal is a glorious and challenging assignment due to the quantum of authority exercised by him. But the proven ability as a teacher does not guarantee an effective administration. One might fail in the new role of administrator and bring chaos in the organization. The success here in fact depends upon whether or not one has managerial skills and how does the person put to use these skills. In fact the challenges of an administrator start from the very day one occupy the chair and starts planning for betterment. Organizations are getting complex everyday and problems are bound to appear. In such a situation administrators with good managerial skills keep the problems at arms length and even if the problem arises it is sorted out by logical thinking. In spite of best efforts of the principal some problems remain unsolved or partially unsolved and may take the form of conflicts putting a further challenge for the administrator. Resistance to change is the basic human nature, which further leads to organizational conflicts that need to be handled by the administrators by safeguarding the well being of all the interest groups. Thus the people in the administrative posts in educational institutions have to be all rounder, maybe in it is technical aspect i.e. teaching assignment, human aspect i.e. dealing with the people or it is conceptual skill part i.e. dealing with future and translating the organizational goals in to reality. Administration of well educated and enlightened elites of the society make the job more challenging when compared with other administrators, and requiring multi-skilled personalities in educational administrators. The Table – 1 presents the various managerial skills available in the educational administrators of the state.

Table I
VALUE OF CONFIDENCE LIMIT, TEST OF SIGNIFICANCE AND F-VALUE OF MANAGERIAL SKILLS

	Style Dimension	Percent	95%Control Limit x? 1.96 ?/?n		F-Value	
			UCL	LCL	Obtained	Table
Problem Solving Style	Sensation Intuition Thinking Feeling	36 14 37 13	30.06	19.04	3.51	2.95 (.05 Level)
	Group Mean	Standard Deviation	?^{2} Value		F-Value	
			Obtained	Table	Obtained	Table
Locus of Control	67	14.35	10.02	17.3	35.38	4.41 (.05 Level) 8.28 (.05 Level)
Conflict Handling Style	12.83	2.97	3.99	9.49	11.37	3.49 (.05 Level) 5.95 (.05 Level)

Problem Solving Skills

The educational administrators of the day are confronted by diverse type of problems and they have to gather and evaluate the information for solution of the problem. Generally the information is gathered through sensation or intuition, and the same is processed by thinking or feeling. Individuals gather data either through processing the facts and details in the environment in a very methodical fashion – *sensation* types – or through global visualization of what the sense depicts – *intuition* types. The sensation type administrators, depend on a lot of information to assess the situation, are pragmatic and down to earth, and concentrate on the present time. The intuitive type, on the other hand, relies on hunches and non-verbal cues, simultaneously considers several alternatives and quickly discards the non-viable ones, is very imaginative, and is more futuristically oriented. Administrators evaluate and make judgments either in an impersonal and objective fashion – the *thinking* types – or in a more personal and subjective manner – the *feeling* types. The thinking type administrators make systematic enquiries, are unemotional, and highly analytical and rational in making decisions. The feeling type administrators place much reliance on human feelings and emotions, are very empathic, sentimental, and try to read between the lines while evaluating situations. The thinking type administrators feel comfortable when logic and good analysis are the bases of decision-making, and are generally unemotional and not very sensitive to the feelings of others. Feeling type administrators enjoy pleasing others, dislike telling people unpleasant things and heavily emphasize the human aspects of dealing with organizational matters. Based upon the above two categories with two variables each, the exact problem solving styles of educational administrators have been studied. The results of the Table – 1 unfold that the administrators of the day gather information on sensation basis and not by intuition, which infuse objectivity in the information collection. Further they analyze the information by cognition i.e. by thinking not by heart i.e. by feeling.

This shows very logical and sound problem solving styles of the administrators and thus can be inferred that educational administrators are highly sensational and thinking oriented and not governed by intuition and feelings due to their score being much below even from the lower control limit. Further these findings are also confirmed by the application of F-test (ANOVA) at 95 percent confidence level.

Locus of Control

The concept of locus of control denotes whether a person believes that they are in control of events, or events control them. Those who have a high internal locus of control believe that they control and shape the course of events in their lives, while those who have a high external locus of control tend to believe that events occur purely by chance or because of factors beyond their own control. Internals, as compared to externals, seek more job related information, try to influence others more at work, more actively seek opportunities for advancement, and rely more on their abilities and judgment at work.

Results of the Table – 1 reveal the state of internal locus of control amongst the educational administrators. As per the results 67 percent of them believe that they control their destiny themselves whereas the other 33 percent believe more in luck or chance and attribute their attainments to luck or chance factor. When the data was testified at 95 percent confidence limit around mean, majority of the administrators have been found with higher internal locus of control. However the standard deviation of 14.35 depicts that some of the educational administrators are having maximum variations on the variable of locus of control. For further authenticity of the results F-test (ANOVA) has been applied, and the obtained value has been found greater than the table value of the same at both levels of significance. Thus the entire discussion given as above testifies that the majority educational administrators of the day have moderate to high internal locus of control and consider themselves more as self-made and believing in their own competencies, and less being governed by destiny.

Conflict Handling Skills

The ability to handle conflicts is undoubtedly one of the most important interpersonal skills an administrator needs. The term conflict refers to perceived incompatible differences resulting in some form of interference or opposition. Whether the differences are real or not is irrelevant. Traditional view on conflict is that conflicts are bad and must be avoided, but human relations views on conflicts consider them a natural and inevitable outcome in any organization. Most recent, the interaction’s view on conflicts proposes not only that conflicts can be a positive force, but also that some conflicts are absolutely necessary for an organization to perform effectively. Hence an administrator should promote and encourage functional conflicts, and should manage and handle dysfunctional conflicts. Understanding and implementation of conflict resolution tools largely depends upon the possession of skills by an administrator. Generally an administrator has five conflict handling options i.e. avoidance, accommodation, forcing, compromise, and collaboration. All the conflicts do not require assertive action rather sometimes conflicts also need to be avoided in a situation when it is trivial, and emotions are running high and time is needed for conflicting parties to cool down. But large segment of conflict handling styles fall in the rest of the four categories.

It can be examined from the Table – 1 that none of the conflict handling styles of the administrators fall in high or low category rather all the scores fall either in moderately high or moderately low category. The results of the table envisage that administrators largely go for collaboration style of conflict handling with a very positive approach of ‘I win, you win’. It is typically characterized by open and honest discussion among the parties. Second popular conflict handling style of the administrators has been discovered as dominating/forcing style with an approach of ‘I win, you lose’. In this style the administrator uses his formal authority to resolve a dispute. Forcing works well when one need a quick resolution on important issues where unpopular actions must be taken, and commitment by others to the solution is not crucial. Compromise and accommodation have been found comparatively least preferred conflict handling styles amongst the administrators as the score in these both categories is less than the mean score which itself is the testimony of the least applied conflict handling styles. At 95 percent significance level around the mean, only three conflict-handling styles could fall in the range and finding the accommodating style i.e. ‘I lose, you win’ a very rarely applied style of conflict handling. The results of $?^2$ test reveals that the observed value is less than the table value, and hence supporting the scale. When further tested by applying F test (ANOVA) to test the authenticity of the above results the same have been in tune discussed as above.

Findings on Organizational Climate

People are affected by the culture and climate in which they live. For example, a person growing up in a middle-class family may be taught the values, beliefs, and expected behavior common to that family, and the same is true for organizational participants. The society has a social climate; a workplace has an organizational climate. When people join an organization, they bring with them the values and beliefs they have been taught. Quite often, these values and beliefs are insufficient for helping the individual succeed in the organization. The person needs to learn how the particular enterprise operates and it is here where the organizational climate has a great role to play. Impact of climate on organization’s performance and effectiveness is both functional as well as dysfunctional. Talking about the later, it may be stated that culture/climate leads to “group think”, and may turn out to be collective blind spots, and resistance to change and innovation. Organizational climate basically reflects a person’s perception of the organization to which he belongs, and encompasses the set of characteristics and factors influencing their behaviors. Thus organizational climate is not a unitary concept rather a composite of many factors. An organization has a structure; it reflects class relation; it has roles; ownership is defined in definite terms. The various elements of an organization contribute to the psychological environment of the same. The various factors influencing the organizational climate mainly include eleven aspects like communication, performance standards, support system, warmth, responsibility, reward system, identity, conflict resolution, participation in decision-making, structure, and motivation level. With regard to the results of these different variables a very positive picture has emerged and all the variables have been found contributing significantly for a performing organisational climate as depicted in Table – II.

Table II
ORGANIZATIONAL CLIMATE IN THE EDUCATIONAL SERVICE SECTOR

Climate Dimension	Group Mean	Standard Deviation
Performance Standards	3.57	0.46
Communication Flow	3.56	0.45
Reward System	3.50	0.68
Responsibility	3.35	0.58
Conflict Resolution	3.68	0.47
Organizational Structure	3.03	0.86
Motivation	3.87	0.43
Decision-making Process	3.48	0.26
Organizational Support System	3.51	0.35
Warmth	3.37	0.70
Identity Problem	3.90	0.38

The results of the Table – II envisage the very positive views of the educational administrators on the types of climate prevailing within their respective institutions. On majority of the eleven variable group mean has been found more 3.5 with very less standard deviation revealing a very dazzling picture of climate. However, views of the respondent unfolds that the organizational structure in the educational institutions is not unidirectional. At some places it indicates at the working contrary to the principle of span of management, at other it signifies the value of rules and regulations, and on some of the occasions, the precedents overtakes the rules, policies and procedures. The group mean of 3.03 also does not point out a complete democratic structure; rather it depicts a mixture of democratic and bureaucratic structure. Like wise, on responsibility and warmth variables, though state of affairs is much performing yet with a good scope for improvement. Motivation and identity problem are the two variables which have recorded a very encouraging picture of the organisational climate. The prevailing organisational climate is communicative enough with realistic performance standards, and a well-defined reward system. In this service sector people feel and perform their responsibility, and the human relation environment has been found quite conducive where the administrators encourage largely democratic structure and participative goal setting to make the atmosphere motivational one. People in the sector work as a team, making the employees more committed to their organization and profession as well. As a whole the overall representation of organisational climate in the educational service sector has been found quite encouraging and performing.

Findings on Interactional Analysis

In fact decisive significance of the present study lies in studying the interaction between managerial skills of the administrators and the organizational climate they are working in. Though these two are the distinct research problems which can be carried out at independent levels yet in the present section of the investigation the researcher has made an effort for the interactional analysis in a composite way. Managerial skills in itself are a very vast area of study and encompass soft skills, their core competencies, technical skills, human skills, and conceptual skills. In the educational institutions an administrator is expected to have a reasonable amount of all the skills. Organizational climate on the other hand is an umbrella term and includes each and every aspect of organizational functioning, which may affect or get affected from the individuals working in the organisation. To study the interaction among these variables first the researchers have tried to study the relationship of scales on pair basis i.e. managerial skills' interaction with organizational climate and thereafter the interaction has been attempted between the two.

The interaction between managerial skills and organisational climate has been found out through interaction table of measures and by applying ANOVA (Table – III and Table – IV). The organisational climate has been grouped in to three categories i.e. performing climate, average climate and poor climate. The interaction table of measures of managerial skills and organisational climate (Table – III) reveals that apex level of organisational climate can enhance the level of various managerial skills and similarly a poor score on climate can hamper the performance of managerial skills. The table further envisages that organisational climate has highest bearing upon the administrators' conflict handling styles i.e. in relation to the poor organisational climate, conflict handling skills of the administrators are affected much. Further the problem solving skills of the administrators are not affected much irrespective of the level of organisational climate, and the same has a moderate impact on locus of control.

Table III
MEASURES OF MANAGERIAL SKILLS AND ORGANIZATIONAL CLIMATE
(INTERACTIONAL TABLE)

Managerial Skills / Levels of Climate	Problem Solving Styles	Locus of Control	Conflict Handling Styles
Performing	25.2	32.7	16.4
Average	25.5	21.2	15.5
Poor	23.0	14.2	9.2

The interaction table has been further analyzed by applying ANOVA to study the interactive effect of various levels of organisational climate and various measures of managerial skills (Table – IV). The findings of the same bring out a significant interaction between overall managerial skills and organisational climate because the observed value of F is higher i.e. 3.56 as compared to its table value 2.15 (.05) and 2.94 (.01). Since the observed value is greater than the table values at both the levels of significance that supports the above mentioned discussion that there is a significant interaction between managerial skills and organizational climate. To authenticate the above findings, ANOVA has been applied to study the interaction between individual managerial skills and overall organisational climate (Table – IV) and the results have been found inconsonance with the above outcome. Locus of control and conflict handling styles of the administrators have found significant interaction with organisational climate at both the levels of significance, but interaction between problem solving skills of the administrators and the organisational climate has been found insignificant at both the levels of significance.

Table IV
MEASURES OF MANAGERIAL SKILLS AND ORGANIZATIONAL CLIMATE
(ANOVA TABLE)

Interactional Analysis	Value of F		Level of Significance
	Obtained Value	Table Value	
Problem Solving Styles x Organizational Climate	0.20	4.26 (.05) 8.02 (.01)	Insignificant at both the levels
Locus of Control x Organizational Climate	13.38	4.26 (.05) 8.02 (.01)	Significant at both the levels
Conflict Handling Styles x Organizational Climate	43.00	4.26 (.05) 8.02 (.01)	Significant at both the levels
Overall Managerial Skills x Organizational Climate	3.56	2.15 (.05) 2.94 (.01)	Significant at both the levels

Conclusion

In fine it can be concluded that administrators in the educational service sector largely solve the problems by use of cognition and logic, and have a moderate to higher amount of internal locus of control. While handling the conflicts they attempt to handle the same with a positive bent of mind i.e. collaboration style, and on failure only resort to alternative styles. The climate in which the administrators are showing their skills is communicative enough with realistic performance standards, and a well-defined reward system. In this service sector people feel and perform their responsibility, and the human relation environment has been found quite conductive where the administrators encourage largely democratic structure and participative goal setting to make the atmosphere motivational one. People in the sector work as a team, making the employees more committed to their organization and profession as well. Further the interaction between the two aspects is more significant in institution building when both work together instead of a pair basis where the mediating variables play a dominant role in the performance.

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The Seize (Capture) of the State: A Chilean Perspective

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Abstract

Chile, being one of the countries selected as a model to be followed as an example of a successful open market economy, is an example of how the State can be captured and re-directed in order to favor a few big investors. According to Transparency International however, Chile is still the less corrupted country in Latin America. Evidences are that the corruption process is present, making it necessary to introduce urgent correction measures.

The purpose of this paper is to analyze the Chilean situation, disclose the corruption procedures used by unscrupulous persons, companies and political agents and others, protecting their selves under the globalization umbrella. There are some cases demonstrating that the Chilean State has reached a high level of capture from domestic and foreign interests. By identifying the illegal or illegitimate operations, signaling the weakness of the system and procedures used to obtain illegitimate profits, it is possible to call the attention on the need to minimize two types of damage: to the national Treasury, and to the less favored people with the wealth distribution.

Introduction

The concept of "Seize the State" is very new. The germinal document containing the concept is "*Civil Liberties, Democracy and the Performance of Government Projects*[1]. Besides introducing the term and its implications, the authors linked it in a chain where globalization-governance-corruption-wealth distribution-poverty was the connecting links. The fatherhood of the term is associated to Daniel Kaufmann, Head of the Governance, Regulations and Finance Group, belonging to the World Bank Institute. However, it was documents such as *Corruption and Institutional Reform: the Power of the Empiric Evidence*[2], *Seize the State, Seize the Day: State Capture, Corruption and Influence in Transition*[3], and *The Governance is Essential*[4], which definitively posed the recently developed term. In spite of the fact that the *seize of the state* is an accepted concept already, it does not mean that it is widely known or that it belong to the public domain, due to its novelty.

Seize of the state is defined as "*the attempts made by companies to exert influence in law promulgations, State regulations and policies, in exchange of illegal payments – under privacy terms - made to state employees*[5]". Authors establish a difference between *corruption*, applying it to misusing a state position in order to obtain personal benefits, and *fraud*, which is applied when the same illegitimate activity occurs in the private sector.

Corruption is not a consequence of modern life. There exists evidence that corruption was a part of the way of living in civilizations as old as the ancient Egypt, Babylon, Greece and Rome. Even the Bible and Koran contain specific references to this phenomenon[6]. However, nowadays corruption has suffered a significant increase due the neo-liberal ideology which is the basis for market globalization. Under this ideology, all kinds of ruling meaning a blockade to the market freedom forces, must be minimized or eliminated in order to reach economic success. The philosophy of *the invisible hand of market* acting to correct any deviation that market actors could generate has relegated State to a minor role. The huge transnational companies can and (in fact they exert) pressure on small countries until the point they can even participate in the ruling and laws promulgation favoring them[7]. Unfortunately, Chile is a country where the power of transnational companies on State can be verified[8].

Governance and Corruption

Governance followers and agents have had a close look on corruption affecting state institutions. Among the publications in Spanish dedicated to analyze the corruption phenomenon, the *Governance, Novedades en la Web*, issued by the Institut Internacional de Gobernabilitat de Catalunya, IIGC, are outstanding. Besides, the World Bank holds a wide data base on the *governance* subject which can be accessed by four different ways[9],[10]

The Governance is composed by the following factors: a) Government election, supervision and substitution process, and accountancy mechanisms; b) Government ability of efficiently managed public resources; to elaborate the setting up and implement policies and laws to take care of development and people welfare, and c) To gain respect from the citizens and the State towards institutions predominating the national economic and social relationships. All these measures are quantified by international indicators. One of the most important indicators; is the level of corruption existing in the country[11].

According to World Bank "*corruption flourishes where policies creates an incentive for it, and institutions whose mission is to restrictive it, are weak. Diagnosing corruption helps any country to understand deficiencies in their policies and institutions, likewise to design an strategy to fortifies the State performance*[12]"

Corruption can assume a variety of formats: misuse of public money, robbery to the State; bribes to avoid denounces on price increase of goods or services sold to the State, or to decrease the quality of these goods or services; bribes to gain monopoly power in the market or in the goods or service acquisition; seizing properties belonging to the State, and a long list of etceteras. It is necessary to mention that if corruption did not exist, enterprises would have to pay the proper level of taxes they are really due to pay.

Because reality regarding corruption is other than normal, countries governments perceive reduced income in relationship to what they should receive, or suffers losses on the national wealth belonging to all the citizens. Whatever the ways used to default the State, the result is that poorest experiment a reduction on their chances to obtain some benefits from the State, or to obtain some help from the government to ideally acquire the education or health level necessary to alleviate their situation by their own. This situation can be clearly noticed by analyzing the percentage of the national budget devoted to Education and Health services in many countries of the world. Sadly to say, that the situation becomes worst as time goes by.

The seize of the State means the increasing predominant role of private interest over general interest, in a trend which is not confined to small and less developed countries only. The persistent denial of the United States' President to sign the so called *Kyoto Treaty* (in spite of the fact that signing was one of the most important commitments of George C. Bush while he was a candidate to the White House), could be one example. Once elected President, George C. Bush denied signing it, arguing that *"doing it would affect the United States economy"*. Prior to this statement made through the communication media, the same media has been publishing that the USA industrial leaders claim against any rule imposing a reduction in the pollution problem caused by them. It is widely known that the USA industry is the biggest polluter in the world. It is not necessary to emphasize: the power exerted by USA industrial leaders on their President to avoid him accomplishing his commitment on this subject.

To put an end to this part of the study: worldwide, the comments upon the true reasons for the war against Iraq, is that all was a maneuver to allow a couple of USA companies take control on Iraq oil. If this intrigue proves to be effective (and it seems so), the world would be in presence of the biggest example of how the most powerful State was seized to serve the economic interest of a handful of people.

The Seize of the Chilean State: Recent Corruption Cases

Most of the Chilean citizens have been stroked by recent events involving private agents and state institutions, in the framework of the so called "seize of the state". There exists a big concern among the population mainly because corruption actions have meant a big loss for the Chilean state, and because those are events to which Chile, as a country, has not been used to. According to Transparency International[13], Chile is not the less corrupted country in Latin America only, but one of the less corrupted countries in the world.

Generally speaking, during the last period there have been different private and state companies involved in political and administrative situations where ethics has been compromised. The impact in the Chilean society has been contradictory, and the consequences in the short and long run are hardly to anticipate. However, what is clear in these moments is that those abnormal situations have provoked a collapse at a political-institutional level, with a serious impact in the political development of the country, which have forced the highest government authorities to define a strategy aimed to correct all current or future ethical deviations, in order to preserve the continuity of democratic model.

One of the domestic financial scandals, demanding government intervention[14], affected the Public Structure, of the Transport and Telecommunication Minister (MOP), and the Environmental and Territorial Management Enterprise (GATE Inc.). Now, to design a new prevention and control strategy as the one required under these circumstances, requires a complete knowledge on the variety of facts intervening in the wrongdoings and how they impacted the political and democratic systems.

Recent researches reinforced the idea that the absence of mechanisms and solid instruments of democratic basis provoke serious distortions in the State agenda, and the administrative processes which accompany it. And here is where the phenomenon of *the seize of the state* appears in the horizon[15]. There is no doubt that the scandals occurred in Chile that will be synthesized later, represents "one attempt done by a company to influence in the law promulgation and in the government policies and ruling, in exchange of illegitimate payments towards State agents, under a private agreement". In other words, the State has been seized to serve private interests.

The degree to which the State is seized, and the results of the capture, determines the configuration of corruption or fraud acts, according to the character of State or private agent that individuals or entities involved could have. Under this context, Political bodies and Politicians play an outstanding role, whether as direct accountable of what happens at government level under their responsibility, or because they are ethically accountable for all what happens in the democratic environment where they exert their activities[16].

To illustrate the previous statements, it is useful to mention part of Joan Prats` lecture titled "Ethics on Political Performance"[17] during a Seminar held in Belo Horizonte, Brazil, during July 3-4, 2003[18]: "The Law-abiding State does not always advance; sometimes it goes backwards. The same occurs with government corruption and efficiency indicators…, the confidence on political and legal institutions and interpersonal trust have dramatically fallen"

It is obvious that bad political practices, and consequently bad politicians, provoke deep ruptures within democratic institutions. Therefore, the image of the political processes is damaged by wrongdoings weakening the whole structure upon which the democratic system is built.

According to Joan Prats´article, "a bad politician does not really know the reality, he deforms it, introduces false images, creating phony illusions, fear and hopes. They do not transform governance patterns: they are skilled operators of popularized political parties, fragmented and of a low institutionalization. They know how to manage them selves in the sewer of political funding, as to manage the electoral client nets; they assign employment in the state positions under patrimony administrations, manage congress occasional majorities and do transactions with legislators ballots, act as brokers between private sector and laws and ruling promulgations, they decide on biddings where state money is spent, or in privatizations; and they negotiate benefits and exemptions."

The aspects mentioned above point out the need to identify those factors decreasing, the efficiency of governance and democracy, moreover if we take in consideration that in the Latin American region "current democracies float on a deep inequality, and sometimes in a big ethnic and cultural inequity; in the middle of imperfect markets problematically linked to global markets, which emphasize inequality, upon civil and political cultures with a low democratic basis, and plagued by "democrats by default"[19]

MOP- GATE scandal antecedents

In spite of the efforts done by the Chilean political and institutional authorities to avoid this situation that compromises the governance stability, and consequently, the democratic process, there has been a complex situation where, surprisingly, two completely different versions of the same facts try to gain citizen favorable opinions. On one side, the facts have been regarded as one legitimate and plausible way to increase citizen welfare. The other view is that the so called "MOP-GATE case" deserves the title of *national scandal*. Facts are the following:

Through the strange case of one criminal claim introduced by a secretary in the Chilean Justice system, the whole situation reached the mass media. The secretary claimed she suffered a street assault while walking to a bank to deposit a huge amount of money belonging to Gestión Ambiental y Territorial, Sociedad Anónima (GATE

Company). The *assault* finally resulted in auto-robbery, but it prompted the disclosure of a series of irregularities in GATE Company, because the guilty secretary denounced that GATE was a façade organization, whose mission was to hide "political money".

GATE was founded in July 1997, as a closely held corporation. Its mission was to provide services of assessment to labor, watering and environmental business problems, and to development analysis, design and implementation to engineer projects. GATE was awarded with the bidding to perform the personal outsourcing and other assessorship services for a total amount of $ 1,725,000,000, Chilean currency (that is equivalent to US$ 2.430.000), asked by the Public Structure Minister. Through a public report, GATE itself pointed out that they had been hired due to the huge amount of tasks that General Franchising Coordination (CGC). This unit depending from MOP had to perform as a result of the expanded number of franchised projects. The activities performed by GATE were: to prepare, review and evaluate antecedents regarding environmental and territorial analysis; legal, taxes, informatics, financial, communications and administrative matters, besides providing services and commodities ranging from office supplies until transport and communications.

An investigation discovered that there was a complex net of a hidden system of wage payments to beneficiate Public Structure and Transport Minister's employees. This way, they received extra wages. Explanations were that the system had the objective to remunerate- according to market level – high level and experienced professionals, whom otherwise would not accept to work for a State entity. Such professionals were required in order to start an ambitious highway and public structures plan, under the private concessions pushed by the Chilean Government.

The first contracts were signed between 1998 and 1999. In a first review, the Republic General Comptrollership pronounced that the payments were legal in its origin, but in 2001 after a second analysis, they were rejected because the committed amounts were not in accordance with the amounts actually paid. Among the irregular facts discovered, was that about 40 Public Structure Minister Officials received extra fees paid by the private GATE Company to perform tasks that were part of their normal activity within the Ministry. Moreover, the investigation did not arrive to any conclusion certifying that these tasks had been actually performed. The same happened with additional environment evaluation assessment contracts signed between GATE and the Public Structure Minister.

The following Table presents a brief summary of the contracts signed between GATE and the Minister of Public Infrastructure (MOP):

TABLE 1. MOP-GATE CONTRACTS
(CHILEAN CURRENCY; US$ 1 = $700)

	AMOUNT	DATE	OBJECTIVE	PERIOD
1	$35.000.000	SEPTEMBER 16, 1998	ANALYSIS AND ASSESSMENT TO DESIGN A PROCEDURE MANUAL FOR ENVIRONMENT CARE IN FRANCHISED HIGHWAYS	6 MONTHS
2	$48.175.000	OCTOBER 8, 1998	SUPPORT TO THE GENERAL COORDINATION OF FRANCHISED CONSTRUCTION, GENERAL PUBLIC INFRASTRUCTURE DIRECTION, IN THEIR ADMINISTRATIVE AND SERVICES ACTIVITIES.	5 MONTHS
3	$15.000.000	DECEMBER 18, 1998	REVIEW OF NORTH ACCESS TO CONCEPCIÓN CITY PROJECT. COMPENSATION PAYMENTS FOR NON INCLUDED TASKS IN THE ORIGINAL FRANCHISING PROJECT.	10 DAYS
4	$49.400.000	MARCH 1, 1999	SUPPORT TO THE EXECUTIVE UNIT OF EXPROPRIATIONS FOR FRANCHISED CGC PROJECTS, IN THEIR ADMINISTRATIVE AND SERVICES ACTIVITIES.	N.A.
5	$49.044.524	JUNE 4, 1999	TO PERFORM SEVERAL ACTIVITIES PROVIDING INFORMATION ON FRANCHISED PROJECTS;	4 MONTHS

			INFORMATION GENERATION AND EXCHANGE AT NATIONAL AND INTERNATIONAL LEVEL.	
6	$966.000.000	SEPTEMBER 13, 1999	SUPPORT TASKS FOR CGC.	12 MONTHS
7	$39.000.000	DECEMBER 6, 1999	DESIGN AND PRINTING OF AN INDEPENDENT ENVIRONMENTAL AUDITING PROCEDURES MANUAL FOR ROUTE 5 FRANCHISING, SANTIAGO-TALCA SECTION	45 DAYS
8	$49.500.000	JULY 18, 2000	ENVIRONMENTAL ANALYSIS	90 DAYS

In Fig. 1 below, there is a representation of how the complex income-disbursements mechanism existing between GATE and the Minister operated.

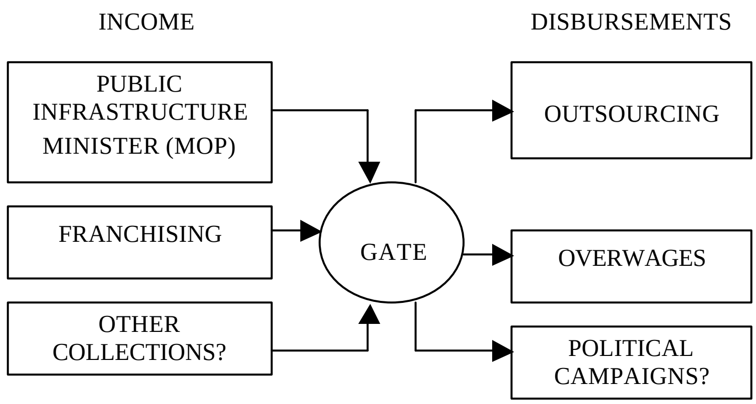

FIG. 1. MOP–GATE-CIADE CASE; INCOME-DISBURSEMENTS RELATIONSHIP[20]

According to Minister Authorities, payments made to GATE were applied to fund operational expenses of the Franchising Coordination, which did not have its own budget, and had a payroll of 4 full time employees only. The remaining required personnel hired on a temporal basis, and received honorariums instead of wages. The same system was used to hire Minister, officials. Although the actual reason for these payments is still under legal investigation, three possible answers have been stated:

1) Payments were an indirect method to fund the Franchising unit.
2) Payments were an uncovered way to fund political campaigns favoring government candidates.
3) Payments were an uncovered way to pay for privilege information that would help GATE win the Minister Infrastructure construction bids.

Besides the previous facts, by analyzing the GATE accounting documentation, several payments were discovered to compensate some never clarified "expenses" made by the Minister. It is suspected that these particular payments were just electoral contributions favoring government candidates.

Around mid 2001, the Public Infrastructure Minister nullified the contract with GATE, invoking cost reasons, and assigned it to the Institute of Economics, Universidad de Chile. However, the irregular payments to state officials continued, and new investigations are on the way, but now headed by both, The Republic General Comptrollership and the Chilean regular legal system.

In a very recent development, the Judge in charge of the judicial procedure, stated[21]:

1. Participation in this case included state agencies, and private and state individuals.
2. The facts analyzed during the legal process could configure a fraud and swindle against the Chilean Treasury, behavior penalized under articles 239 and 468 of the Chilean Penal Code.
3. There are assumptions of persons exerting state employments, whom used their position to inflate consultant services to pay amounts not authorized by the State. Among these payments there were

additional honorariums and fees in favor of people not included in the official payrolls. These payments mean a robbery to the Chilean Patrimony.

4. Additionally and jointly to the previous maneuver, people whom were not state employees colluded with State officials to inflate consulting fees, or facilitating their firms title with the same purposes, completely aware that the services would not be rendered by the "hired" firm.

Conclusion

After reviewing one of the cases recently occurred in Chile, where the seize of the state maneuver is clear, many conclusions are possible to obtain. Among them:

1) Taking into account that ethical code we apply to orientate our behavior derivates from the culture our society environment we live in, the more an individual goes deep into society, more complex are the rules that she/he must observe. In the same vein, the highest the hierarchal position an individual reaches it is more likely for him or her to face ethical dilemmas while deciding among opposed interests. Decisions must harmonize personal, group, public, organization and country interests. This is why the "guilty mistakes" corruption activities or misconduct in general, coming from high position government authorities, are inexcusable.
2) The corruption scandals disclosed affects a country worldly known – through International Transparency Agency several reports - as the less corrupted country in Latin America, and one of the less corrupted countries of the world, including a number of developed countries. On these bases, it is easy to deduct what the situation should be in those countries considered as corrupted.
3) The last developments in the reported Chilean cases have demonstrated that they are not completely illegal. But, it is equally possible to say they are not legal either. There are some gaps in the laws allowing "interpretations" which put the authors of the wrongdoings in a legal "no man's land", away from where the law can reach them.
4) The seize of the state is acting in Chile, through unscrupulous state employees, and fortunately the corresponding information has reached the citizens knowledge on time (GATE scandal). Administration failed since controls were in site, but because negligence or corrupted officials were in charge to reinforce it. The portrayed case could have been avoided if the respective State entities or agents had duly accomplished his/her duties. It has not been proved yet, but is supposed that bribes could have exerted its pervasive influence on them.

The phenomenon called *Seize of the state* is still under study not only regarding their characteristics, but mainly about their effects and future consequences. Until now their advance has been headed by the Group of Governance, Regulation and Finance of the World Bank Institute. The subject is important enough to deserve further research from Govemance specialists, and from researchers from different study fields, whom could help to clarify this worrying and relevant new problem, in order to propose solutions.

The World Bank, given its nature, has assigned maximum relevance to the economic impact upon the seize of the state, and put some attention on their social effects (poverty increasing, wealth distribution inequity and environmental damage, for instance). However, this institution has not gone deeper in the phenomenon explanation.

In absence of a satisfactory general answer, some voices have claimed that the seize of the state is just another unwanted product of globalization and neo liberal economic philosophical application. This creates a situation where a more careful analysis is urgently required: the reaction could be from the massive population excluded from a global wealth distribution. Demonstrations against World Commerce Organization were small at beginning, but they started growing thereafter, and right now nobody knows what the future could bring on this subject. Anomy is already present in some societies, and when this decomposition of the social fabric starts deteriorating the consequences can be extremely dangerous.

The most important effect of all these illegitimate procedures have been the lack of confidence that citizens have experienced against state agencies procedures, and on the politicians activities. In other words, there has been mayor damage to the political system and its institutions. Consequences on political authorities are an image of credibility seriously eroded, and doubts on their ability as leaders and persons able to guide and sustain democracy on an institutional basis. Another of the unwanted results is the high risk that skilled and efficient professionals working for the State quit the system, and that new professionals willing to work for the State feel repulsion to do it, because of the danger of damaging his/her personal reputation.

In summary, the worst effect from all these happenings is the loss of confidence from citizens on state institutions, including the ability to exert a minimum of control on the institutions devoted to provide common welfare. The uncertainty created after this scandal (and others not mentioned here) is now a phenomenon appearing each time someone accuses the state institutions or government authorities of wrongdoings, no matter if afterwards procedures discover that nothing abnormal have occurred.

Furthermore, it is amazing to realize that almost every agent in charge of reinforcing the Chilean laws, in the sense of protecting the national interest over the foreign ones, have been ready to admit their failures, but claiming innocence on the basis of the same law they were supposed to obey. In many cases, highly educated university professionals declared themselves *unable* to distinguish the difference between tax elusion and tax evasion, provoking a severe damage to the Chilean economy.

Finally, if political and opinion leaders, university scholars and citizens worry about the phenomenon of the capture of the state and its consequences, it is very likely that state agencies be reinforced and strengthened to stop corruption, repair negative effects that globalization has brought and enhance the positive ones. If these goals are reached, what actually would be obtained is nothing less than to give to social equity the importance it really deserves.

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b) Data with interactive exhibits, Excel file (670kb), Zip file (188kb);

c) World maps, Power Point file (265kb), Zip file (151kb) and,
d) Governance Researchs in different countries Investigaciones (Snapshot) (GRICS)

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Accounting Information in the Context of Internationalization: Theory and Practice of Slovene Companies on Markets of Former Yugoslavia

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Abstract

In the second half of the nineties the internationalization of Slovene companies started to expand into more and more active forms. Export business was complemented by increased foreign direct investment either as joint ventures or as independent investment into existing or newly established companies. Disregarding the chosen internationalization strategy, support from information function is crucial to its success. In this article the role of accounting function [as central part of information subsystem] in internationalization process will be presented. We believe that managers of Slovene companies do not use accounting information for control over their operations on markets of former Yugoslavia adequately. In case of exporting, accounting information represent basis for decision-making related to determination of prices, terms of payment and evaluation of sales. The importance of accounting information is further increased in companies that choose investment approach to internationalization. In addition to international transfer pricing issues, which are related to diverse tax legislation and tax rates in different countries, accounting information represent the basis of control over business activities and evaluation of foreign subsidiaries and their management on the markets of former Yugoslavia.

In the process of globalization the strategy of internationalization has become one of the strategies that top management devotes most of its attention to. A company without a strong strategy of entry to foreign markets is a myopic company, characterized by unplanned, ad hoc solutions to changing market conditions, increase of competition on foreign markets in particular. Such an approach, referred to as "selling" approach by Jaklic [9], can not be part of successful integration into globalization flows. Coordinate performance of all business functions is necessary and the only way to achieve it is by adequate use of information for decision-making, prepared by accounting department of a company.

In the first part of the article the phase model of internationalization will be presented. We argue that Slovene companies that enter the markets of former Yugoslavia use this model as their entry mode. The results of the research entitled "Behavior of Slovene companies and strategies of entry into markets of former Yugoslavia" show, that majority of Slovene companies (65 out of 119) are already present on these markets. Only 29 of them operate through subsidiaries, established on these markets, while others concentrate on export business. The fact that Slovene companies gradually increase their involvement in markets of former Yugoslavia is further supported by the fact that 23 companies, which currently export, plan at least one foreign direct investment in at least one of the markets of former Yugoslavia in the next three years and that 20 companies, which already own subsidiaries in these markets plan at least one new investment in the next three years.

In the second part of the article we demonstrate, why importance of accounting information for control over activities on markets of former Yugoslavia increases with level of involvement into these markets. One of the main tasks of accounting function is preparation of accurate and important information for internal users [managers] for decision-making related to purchase, sales, finance, human resources and production functions. Increased involvement into a particular market raises importance of accounting information related to determination of selling prices, maintenance of financial discipline of buyers, evaluation of sales, foreign subsidiaries and their management. Neglecting such information, which results in decision-making by instinct, therefore leads to taking sub-optimal decisions and deterioration of business results. Hypotheses, which were used to test to what extent decisions, related to activities on markets of former Yugoslavia, are based on accounting information, are placed in the center of the second part of the article. Related to accounting information for decision-making in *foreign* business environments, our research complements research of Slovene authors [5, 10] who point out inadequate use of accounting information for management decision-making in Slovene companies. In the closing part of the article main conclusions, resulting from our research, will be presented.

Internationalization as a Process

International comparative advantages, related to foreign direct investments, changed in the nineties, when low costs of labor and natural resources started to loose importance. On the other hand, importance of highly educated workforce and development of infrastructure started to increase. As consequence of this turnabout, the trend of increasing foreign direct investment in North America, Far East and the European Union re-appeared [11]. From the viewpoint of "western capital" the markets of former Yugoslavia started to internationalize too late. In addition to familiarity with business environment, culture and recognition of trademarks in the region, this was an additional reason for Slovene companies to perceive high opportunities on these markets. Theory of gradual internationalization into foreign markets derives from Scandinavian school and is predominantly based on international studies of Swedish researchers. The theory points out two internationalization processes that run in predictable sequence:

- gradual penetration in new markets, starting with markets with low cultural distance and slow approach to more demanding markets and markets with high cultural distance;
- gradual involvement in and dependence upon particular markets;

Both processes are based on assumption of risk-averseness and are related to the learning process. In the first case, the company can use knowledge, gained on one market, to enter the next market. In the second case, the company can decrease risk, related to higher internationalization stages, with use of newly acquired knowledge on particular market.

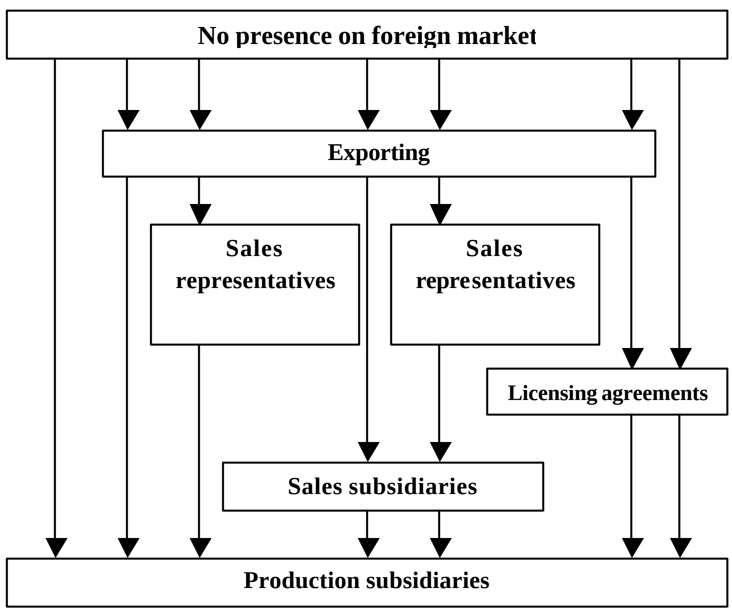


FIG. 1: DIFFERENT MODES OF INCREASING INVOLVEMENT ON FOREIGN MARKET

[3]

In continuation we present two extreme strategies of entry: exporting and foreign direct investments. By doing this, we investigate similarities with strategies of entry of Slovene companies on markets of former Yugoslavia and factors which influence these two strategies. After that we will relate both entry modes to crucial accounting information for control over activities on markets of former Yugoslavia.

Export strategy

Exporting represents the simplest form of presence on foreign markets. Although it minimizes fixed costs, such costs [making contacts with potential buyers, negotiating prices, organizing transportation, transforming products, advertising costs etc.] are still so high, that the realized contribution margin does often not cover fixed costs related to transaction. Consequently, low level of export is often not economically warranted.

Due to high price elasticity, which arises from low levels of income, increase of prices as consequence of transportation costs and duties have a strong negative effect on sales. Existing deficit in balance of payments results in additional non-duty barriers for Slovene exporters, and the problem increases with the value of exports.

Foreign direct investment in foreign subsidiaries

In transition economies, governments have to make a choice between increasing level of foreign direct investment, in order to overcome the problems of lack of local capital, access to new technologies and managerial know-how on one hand, and keeping level of such investments low, in order to avoid criticism of selling out national properties to foreigners on the other hand. In Croatia, Bosnia, and Macedonia the legislation is supportive to foreign direct investment. Although foreign direct investment is a risky form of presence on foreign market, the level of risk varies with types of investment:

Joint venture as a form of co-operation between two or more business partners has evolved relatively late. Its development is related to increased costs of research and development, decreasing lifecycles of products, decreasing time from first conception to launch of new products and lack of financing. Due to these trends, the companies were forced to give up complete control over all business functions. The characteristic of the joint venture strategy is the establishment of a new company, which is legally separated from both [all] partners, who share the ownership, management and control over its operations. Two principal advantages of this strategy are conformity with demands of local governments, demanding participation of local capital in foreign direct investments and decreased risk, related to involvement in a particular market. The risk can be further reduced if the partners have already co-operated in the past. Familiarity with the partner, its abilities, business ethics, culture and existing personal contacts represent an additional factor of lowering risk through the joint venture strategy.

Foreign subsidiaries in 100 % ownership are the most risky form of presence on foreign markets. The most usual reason for such entry strategy is presence of some specific component [such as specific managerial know-how] that could be lost in licensing agreement or joint venture strategy. On the other hand the cost of such strategy is higher and in case of deterioration of market conditions the company takes over all the risk and can not easily withdraw from the market. Operating through foreign subsidiaries is related to issues such as diverse tax legislations and related problem of international transfer prices as well as evaluation of subsidiaries and their managements.

In the next section we focus on importance of accounting information in control over operations on markets of former Yugoslavia. Such information is prepared by management accounting that encompasses a wide specter of techniques for solving managerial problems. Hansen and Mowen [8] distinguish three main areas of management accounting:

- determination of cost prices of products and services,
- preparation of information for management decision-making and
- preparation of information for planning and control [including evaluation];

The Role of Accounting Information in Control over Operations on Markets of Former Yugoslavia

Importance of accounting information increases with dependence on particular foreign market. In the beginning phase of entry on a foreign market, the company adopts to existing market conditions by setting prices on the level of prevailing market prices or below market prices to increase market share. Accounting information related to cost prices of products are of secondary importance, because strive for gaining market share prevails. Increased dependence upon the market results in closer control over profitability of such operations. Recognition of trademarks allows the company to differentiate from its competitors and following market prices or setting prices below them is no longer necessary. On the long term the price has to cover full cost and allow for an appropriate profit rate. Importance of accounting function, that prepares information basis for pricing decisions, is therefore increased with dependence upon foreign market (measured by the proportion of sales, realized on a particular foreign market, in total sales]) Our first hypothesis is therefore:

> **Importance of accounting information for decision-making related to pricing policy increases with increased dependence upon markets of former Yugoslavia: in the beginning, prices are set at level of prevailing market prices or below market prices; when companies become more involve d into foreign markets, prices are set at full cost, increased by calculative profit.**

We asked the managers of Slovene companies on what basis prices on former Yugoslav markets were being determined. For comparison we were also interested, how these were determined on markets of the European Union. An encouraging conclusion, that can be drawn from Figure 2 is, that prices on markets of former Yugoslavia are set predominantly on full cost plus profit. There are also a number of companies that set prices at level of prevailing market prices but without information on relationship between such prices and cost we can not conclude whether such prices allow for realization of profit. Number of companies that set prices at level of production or even variable cost is low, but it is important to point out that almost 20 % of Slovene companies on the EU markets only cover production costs although they realize 2/5 of their sales on these markets. One possible explanation for this poor result is that recognized trademarks of Slovene companies allow for higher prices on markets of former Yugoslavia.

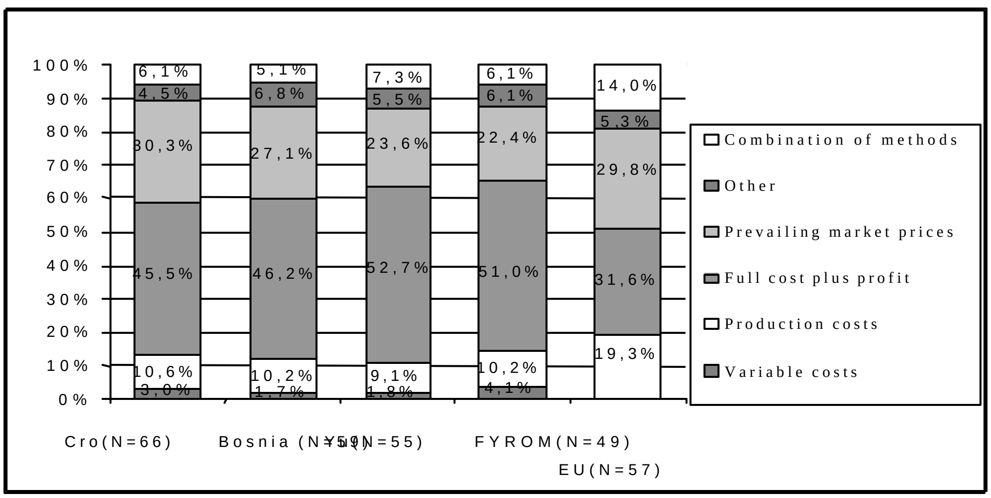


FIGURE 2: BASiS FOR DETERMINATION OF PRICES ON MARKETS OF FORMER YUGOSLAVIA AND THE EU MARKETS

Source: Research "Behavior of Slovene companies and strategies of entry into markets of foreign Yugoslavia", 2001

As we have explained, the price has to cover full cost and allow for an adequate profit in the long run. One would therefore expect that companies, which are more dependent upon a particular market, set prices at full cost level more frequently. All companies in the sample that do business on markets of former Yugoslavia were split into two groups. Companies that set prices on basis of accounting information at full cost were placed into group 1. Companies that use any other pricing basis were placed into group 2. According to our hypothesis we expect, that companies from group 1 are more dependent upon particular markets than companies from group 2. Dependence upon particular market was measured by sales, realized on the market, related to total sales in year 2000. Results are presented in table 1. In order to generalize the conclusion, the t-test for comparison of two arithmetic means of independent samples was used. The following supposition was tested [4]

H_0: $?_1 = ?_2$
H_1: $?_1$? $?_2$

TABLE 1: ANALYSIS OF RELATIONS BETWEEN BASES USED TO SET PRICED AND DEPENDENCE UPON INDIVIDUAL MARKETS (COMPARISON OF TWO ARITHMETIC MEANS OF INDEPENDENT SAMPLES)

	Croatia	Bosnia	Yugoslavia	FYROM	EU
N	63	55	51	46	55
Number of companies in group 1[a)]	29	28	28	24	19
Number of companies in group 2[a)]	34	27	23	22	36
Average % of sales from group 1[b)]	5.31	3.08	0.89	2.54	32.77
Average % of sales from group 2[b)]	7.41	3.73	3.38	1.93	40.45
t-test for comparison of two arithmetic means	0.866	0.541	1.992	-0.444	1.008
Confidence level (2-tail)	0.390	0.590	0.058	0.659	0.318

[a)] Companies that set selling prices at level of full cost were included in group 1, companies that set prices at all other levels are included in group 2.
[b)] Average % of sales is calculated as % of sales on particular market, related to total sales in year 2000.
Source: Research "Behavior of Slovene companies and strategies of entry into markets of former Yugoslavia", 2001.

The data does not allow confirming our hypothesis. Although characteristic relationship between dependence upon the market and level of prices exists in case of the Yugoslav market, the relationship is just the opposite of the expected one: growing share of sales on this market results in lower level of full cost pricing. Although not characteristic, this [reverse] relationship was also noticed in case of Croatia, Bosnia and the EU. The expected relationship was only found in Macedonia where increased level of sales results in more frequent use of full cost pricing. On basis of these results we can not conclude that Slovene companies have built precise pricing strategies on markets of former Yugoslavia.

In addition to pricing, some financial policies are also related to level of involvement into particular markets. One such example is the measures taken to assure financial discipline. For example, the strategy that focuses on increasing market share, leads to increased sales on target market. In this case, realized income represents the most important information. In this period, when the level of sales is still relatively low and when the relations with buyers are still being established, drastic measures when dealing with non-payers are not appropriate for three reasons: 1) because sales related to individual buyers are low, 2) buyers still need time to form their own markets and 3) because financial discipline of buyers is not yet well known and it is therefore not appropriate to take serious measures because opportunity cost of such action could be too high. As market share increases, financial discipline of buyers becomes increasingly important. Strive for increased sales gives place to paid realization as main goal. Because poor financial discipline of an individual buyer is more and more reflected in company's profitability, appropriate measures, such as decrease or complete suspension of supply, legal charges or approval of new supplies on basis of prepayment only, should be taken. At the same time, alternative buyers who could take over its existing share of sales should be sought. Our second hypothesis is therefore:

Importance of accounting information regarding financial discipline of buyers increases with dependence upon markets of former Yugoslavia. The measures taken in case of poor financial discipline become stricter with increased level of sales on these markets.

Probably the best information that shows the level of financial discipline of buyers is yearly percentage of write-offs. First insight into information on the level of write-offs [shown in table 2] draws to the conclusion that Slovene companies do not face very serious problems regarding poor financial discipline on markets of former Yugoslavia. But as it turns out, this is partly the consequence of caution related to terms of payment. Many companies demand prepayments or bank guarantees that, to the highest extent, decrease the level of risk.

TABLE 2: LEVELS OF RECEIVABLES THAT WERE WRITTEN OFF ON MARKETS OF FORMER YUGOSLAVIA AND THE EU IN YEAR 2000

	Croatia	Bosnia	Yugoslavia	FYROM	EU
N	63	58	55	53	59
Number of companies with no write-offs in year 2000	85.7%	87.9%	92.7%	94.3%	66.1%
Maximum percentage of write-offs in year 2000	10.0%	10.0%	90.0%	25.3%	15.0%
Average percentage of write-offs in year 2000	0.49%	0.32%	1.79%	0.50%	0.78%

Source: Research "Behavior of Slovene companies and strategies of entry into markets of former Yugoslavia", 2001.

Dealing with payment problems, the companies can use diverse measures. We asked Slovene managers how important they found the following four measures: 1) decreased supplies, 2) complete suspension of supplies, 3) legal charges and 4) reporting bad experience to other companies; We asked them to mark to what extent they agree with use of these measures on a scale ranging from 1 to 5 [1 – I strongly disagree, 5 – I strongly agree]. The results show that managers prefer legal charges [arithmetic mean 3.62] followed by complete suspension of supplies [arithmetic mean 3.59] and decreased supplies [arithmetic mean 3.49]. They do not find reporting bad experience to other companies particularly important [arithmetic mean 2.37].
Because financial discipline is becoming more important as dependence upon a market increases, we expect a more intensive use of all four measures. Dependence upon a market was again measured by sales, realized on the market, related to total sales. To investigate the relationship between dependence upon a market and importance of measures against bad financial discipline we used the regression analysis and the following model [Churchill, 1995, pg. 892].

$$\mathbf{Y_i = a + bX_i + e_i}$$

Where:
Y: measure against bad financial discipline [decreased supplies, complete suspension of supplies, legal charges and reporting bad experience to other companies]
X: share of sales, realized on a particular market, related to total sales

Because there are four measures and one independent variable, we made four regression analyses. While all four measures have relatively normal distribution, this is not the case with the share of sales. This variable has a pointed distribution and is asymmetric to the left. Results are presented in table 3.

TABLE 3: REGRESSION ANALYSIS OF MEASURES AGAINST BAD FINANCIAL DISCIPLINE RELATED TO DEPENDENCE UPON MARKETS

	Model 1	Model 2	Model 3	Model 4
Dependent variable	Decreased supplies	Complete suspension of supplies	Legal charges	Reporting to other companies
N	64	65	65	64
R^2	0.030	0.018	0.012	0.006
Constant [a]	3.732 [0.000]	3.455 [0.000]	3.733 [0.000]	2.448 [0.000]
Coefficient [b]	-0.016 [0.168]	0.011 [0.289]	-0.009 [0.374]	-0.006 [0.539]

Numbers in parentheses are the 2-tail confidence levels for constant and regression coefficient.
Source: Research "Behavior of Slovene companies and strategies of entry into markets of former Yugoslavia", 2001.

The analysis of data did not point out any characteristic relationships between measures against bad financial discipline and dependence upon markets. As opposed to our expectations we found that the relationship is actually reversed: increased dependence upon a particular market leads to decreased importance of measures against bad financial discipline. This [reverse] relationship was found in three cases [decreased supplies, legal charges and reporting bad experience to other companies] while the expected relationship was only found in one case [complete suspension of supplies]. What causes such behavior of the management is probably high dependence upon markets and related fear of lost sales, which results from the fact which search for new buyers, who would take over the lost sales, is a time-consuming, expensive and risky process.

Increase of sales is also related to evaluation measures. As it derives from the first two hypotheses, profitability of sales is pushed aside in the first period, when strategy of increasing market share prevails. Evaluation measures are therefore closely related to level of sales. In the second period, when the share of sales on a particular market grows, the success of business activities reflects through profit measures [net income, contribution margin and similar]. Our third hypothesis is:

> **Increased dependence upon markets of the former Yugoslavia, results in increased use of accounting information in evaluation process. When level of sales is low, the principal evaluation measure is level of sales. As level of sales grows, profitability measures become increasingly important.**

Slovene companies use different evaluation measures to evaluate their operations on markets of former Yugoslavia. We asked the managers to mark on the scale ranging from 1 to 5 [1 – not important, 5 – very important], how important they find four financial measures to evaluate their operations: level of sales, paid realization, contribution margin and profit. The results show that the most important measure was paid realization [arithmetic mean 4.56], followed by contribution margin and profit [arithmetic means 4.11 and 4.10 respectively]. The level of sales was mentioned as least important measure [arithmetic mean 3.36]. The attention attributed to paid realization leads to the conclusion that managers are aware of risks related to financial discipline on these markets.

According to our hypothesis, we expect that increasing sales lead to more intensive use of net income and contribution margin as evaluation measures. Again, level of sales on a market, related to total sales, was used to measure dependence upon a market. To study relationship between dependence and evaluation measures we used the regression analysis and the following model [4]:

$$\mathbf{Y_i = a + bX_i + e_i}$$

Where:
Y: importance of evaluation measure [level of sales, paid realization, contribution margin and profit]
X: share of sales, realized on a particular market, related to total sales

Because there are four evaluation measures and only one independent variable we carried out four regression analyses. Except for the paid realization measure, which is asymmetric to the right, the distributions of other variables are normal. Results are presented in table 4.

TABLE 4: REGRESSION ANALYSIS OF IMPORTANCE OF EVALUATION MEASURES RELATED TO DEPENDENCE UPON MARKETS

	Model 1	Model 2	Model 3	Model 4
Dependent variable	Level of sales	Paid realization	Contribution margin	Profit
N	68	68	67	68
R^2	0.024	0.015	0.043	0.000
Constant (a)	3.233 (0.000)	4.500 (0.000)	4.011 (0.000)	4.095 (0.000)
Coefficient (b)	0.011 (0.207)	0.005 (0.319)	0.011 (0.091)	0.001 (0.934)

Numbers in parentheses are the 2-tail confidence levels for constant and regression coefficient.
Source: Research "Behavior of Slovene companies and strategies of entry into markets of former Yugoslavia", 2001.

The analysis showed that with increasing level of sales all four evaluation measures were becoming increasingly important. Generalization of this conclusion is only possible for the "contribution margin" measure and even in this case a wider confidence level of 10 % has to be used. We can therefore conclude that the importance of contribution margin increases with level of sales, which is in conformity with our hypothesis.

Importance of Accounting Information for Control over Subsidiaries on Markets of Former Yugoslavia

In comparison with exporting, foreign subsidiaries provide Slovene companies with some specific opportunities. At the same time, operating through subsidiaries calls for more complex information basis for decision-making and performance evaluation. Out of 119 companies that took part in our research, 29 operate through subsidiaries on at least one of the markets of former Yugoslavia. 23 of these have at least one subsidiary in Croatia, 18 in Bosnia, 12 in FYROM and only 6 in Yugoslavia.

We have already mentioned that the internationalization strategy through subsidiaries is riskier than the export strategy. Higher risk is related mostly to incapability to reallocate invested assets into alternative uses in case of unexpected unfavorable circumstances [such as deterioration of economic conditions, changed legislation and similar]. On the other hand, this strategy is related to some competitive advantages that influence establishment of foreign subsidiaries and have positive effect on profit of Slovene Mother Company. These advantages are related to: 1) decrease or complete avoidance of custom duties if the company reallocates production function to their foreign subsidiary and uses local suppliers, 2) decrease of world taxes paid if tax levels in host countries are lower than Slovene tax rate and 3) increase of financial discipline because through centralized financial function the Slovene mother company can supplement lack of financial knowledge and other experience.

Establishment of subsidiaries on markets of former Yugoslavia is related to strive for decreasing customs duties.

We asked the managers of Slovene companies to what extent custom duties influence entry costs to enter markets of former Yugoslavia. They marked their answers on a scale ranging from 1 to 5, where 1 represents low entry costs and 5 represents high entry costs. The question was asked to all the companies from the sample, including those that do not do any business on these markets. The managers perceived highest entry costs on the Yugoslav market [arithmetic mean 3.38]. In other three countries the average grade is below the mean of the scale and does not point to important entry costs [arithmetic means were 2.75 for FYROM, 2.70 for Bosnia and 2.68 for Croatia]. Next, we excluded the companies with no operations on these markets and the results have not changed much. It is interesting to point out that for all four markets the arithmetic means increased [Yugoslavia 3.61; FYROM 279; Bosnia 2.83; Croatia 2.71].

Next, we investigated whether establishment of subsidiaries was related to strive for decreasing customs duties. The companies were split into two groups. Companies with foreign subsidiaries were placed into group 1. Companies that operate on particular markets but have no subsidiaries on these markets were placed into group 2. According to our hypothesis we expect that the companies from group 1 perceive higher entry costs than companies from group 2. Higher perceived entry costs can be viewed as one of the reasons for establishment of subsidiaries on these markets. To generalize the conclusion we used the t-test for comparison of two arithmetic means for independent samples. The following supposition was tested [4]:

H_0: $?_1 = ?_2$
H_1: $?_1\ ?\ ?_2$

TABLE 5: ANALYSIS OF RELATIONSHIP BETWEEN PERCEIVED LEVEL OF CUSTOM DUTIES AND PRESENCE OF SUBSIDIARIES (COMPARISON OF TWO ARITHMETIC MEANS OF INDEPENDENT SAMPLES)

	Croatia	Bosnia	Yugoslavia	FYROM
N	66	60	54	53
Number of companies with subsidiaries (group 1)	22	17	4	10
Number of companies without subsidiaries (group 2)	44	43	50	43
Custom duties represent a high entry barrier (group 1)	3.18	3.12	4.25	3.20
Custom duties represent a high entry barrier (group 2)	2.48	2.72	3.56	2.70
t-test for comparison of two arithmetic means	-1.849	-1.206	-2.235	-1.018
Confidence level (2-tail)	0.069	0.233	0.061	0.313

Source: Research “Behavior of Slovene companies and strategies of entry into markets of former Yugoslavia”, 2001.

Results in table 5 are in conformity with our hypothesis and show the following: companies that operate through subsidiaries perceive [on average] custom duties as an important entry cost. The average on all four markets is above the mean of the scale. On the other hand, companies that export to the markets in question perceive custom duties as less important cost. Because presence of subsidiaries allows for decreasing custom duties, we can conclude that this was one of the reasons of their establishment.

Operating through subsidiaries decreases risk related to financial discipline.

Similar to previous analysis we split the companies into two groups. Companies with subsidiaries in particular markets were placed into group 1. Companies without subsidiaries were placed into group 2. We expect that companies from group 1 have fewer problems with financial discipline of their buyers than companies from group 2. Results are presented in table 6. To generalize the conclusion we used the t-test for comparison of two arithmetic means for independent samples. The following supposition was tested [4]:

H_0: $?_1 = ?_2$
H_1: $?_1\ ?\ ?_2$

TABLE 6: ANALYSIS OF RELATIONSHIP BETWEEN OPERATING THROUGH SUBSIDIARIES AND AMOUNT OF WRITE-OFFS (COMPARISON OF TWO ARITHMETIC MEANS OF INDEPENDENT SAMPLES)

	Croatia	Bosnia	Yugoslavia	FYROM
N	63	58	54	53
Number of companies with subsidiaries (group 1)	22	18	6	11
Number of companies without subsidiaries (group 2)	41	40	48	42
Average percentage of write-offs in group 1	0.74	0.68	0.00	0.00
Average percentage of write-offs in group 2	0.35	0.16	0.17	0.63
t-test for comparison of two arithmetic means	-0.786	-0.926	0.501	0.533
Confidence level (2-tail)	0.435	0.367	0.618	0.596

Source: Research "Behavior of Slovene companies and strategies of entry into markets of former Yugoslavia", 2001.

The results show that Slovene companies that operate through subsidiaries in Yugoslavia and FYROM wrote off less receivables [this relation was expected], whereas the relation was reversed in case of Croatia and Bosnia. Any generalization to the whole population is not possible, because none of the mentioned relations was characteristic. Increasing financial discipline is therefore not one of the main reasons for establishment of subsidiaries on markets of former Yugoslavia. An interesting finding is that in year 2000 Slovene companies from our sample did not write off a single dollar in Yugoslavia and Macedonia. The reason for this is of course not strong financial discipline on these markets but awareness of the risk [five out of six companies that operate through subsidiaries in Yugoslavia requested prepayment for purchases].

Organization units of a company can be viewed as different types of responsibility centers. Categorization of responsibility centers in Slovenia is related to Slovene Accounting Standard 20 that distinguishes the following responsibility centers [12]:

- cost responsibility center
- income responsibility center
- profit center
- investment center

In first case, the head of the responsibility center is only responsible for costs, in the second her responsibility is focused on income, in profit center both cost and income are the head's responsibility and in investment center the head is not only responsible for profit but for return on investment as well. Except in some specific cases [for example when production facility is considered a cost responsibility center] subsidiaries are usually treated as income centers. Their income has to cover all costs and allow for realization of an adequate return on investment. The results showed that Slovene companies bear this theoretical recommendation in mind. 23 out of 26 companies that operate through subsidiaries on markets of former Yugoslavia answered that they used return on investment as evaluation measure for their subsidiaries. The issue of differentiation between performance of a subsidiary as organization unit and performance of its management is very popular in domestic and international literature [Hocevar 1995, Iqbal et al. 1997, Holzer 1994, Belkaoui 1991, Appleyard et al. 1990]. Regarding performance evaluation we were particularly interested whether Slovene companies that operate through subsidiaries distinguish between the two.

Performance evaluation of a subsidiary represents a basis for decisions related to further investment or disinvestments related to the particular unit. For this reason all cost and all income that is directly connected to operations of the subsidiary as well as the part of indirect cost allocated from mother company [such as research and development or similar] has to be considered in evaluation process. On the other hand, evaluation of the management has to take into consideration specific circumstances in which the subsidiary operates. Both, costs and income are influenced by diverse uncontrollable factors. Such categories should therefore not be included in performance evaluation. Only controllable cost and income should be considered. Although the subsidiary realized high profit, it is not always the case that also its management was successful. If high profit derives from an uncontrollable factor such as exchange rate changes, this part of profit should not be reflected in manager's performance evaluation.

The next hypothesis derives from distinction between performance of subsidiary and its management:

All cost and income are considered in performance evaluation of subsidiary, whereas uncontrollable factors are excluded from performance evaluation of management.

We asked the managers whether profit, used for evaluation of subsidiaries on one hand and management on the other, was calculated differently or not. We listed four different costs that are uncontrollable for the management and asked them to specify which of them were considered in calculation of profit. According to theoretical recommendations we expect that the uncontrollable costs will not be included in manager's performance evaluation.

TABLE 7: COSTS INCLUDED OR EXCLUDED FROM PROFIT, USED TO EVALUATE PERFORMANCE OF A SUBSIDIARY AND ITS MANAGEMENT

	Evaluation of subsidiary		Evaluation of management	
Costs, inluded in calculation of profit	Yes	No	Yes	No
- Interests paid	17	8	14	10
- Indirect costs, allocated from mother company	11	14	12	12
- Exchange rate differences	17	8	15	9
- Licensing fees and other cost, paid to mother ompany	11	13	11	12

Source: Research "Behavior of Slovene companies and strategies of entry into markets of former Yugoslavia", 2001.

Results in table 7 are in complete discordance with theory and our hypothesis. In majority of cases, companies use same profit disregarding whether they use it to evaluate performance of the subsidiary or its management.

In the context of performance evaluation another important issue is the problem of international transfer prices. Disagreements between Mother Company and its subsidiaries are most frequently related to transfer prices. The problems are particularly evident in case of internal transfers between profit or investment centers, because transfer prices are an example of a zero-sum game: increased profit of the selling unit [by x] decreases profit of the buyer [by x]. In international environment an additional issue is custom duties and tax rates that vary from country to country. In table 8, information on transfers from Slovene mother companies to their subsidiaries on markets of former Yugoslavia is presented.

TABLE 8: SHARE OF INTERNAL TRANSFERS FROM SLOVENE MOTHER COMPANIES TO THEIR SUBSIDIARIES ON MARKETS OF FORMER YUGOSLAVIA

	Croatia	Bosnia	Yugoslavia	FYROM
Number of companies with subsidiaries	23	18	6	12
Average % of sales of Slovene companies to subsidiaries on partiular market	4.64% (20)	3.11% (16)	0.06% (5)	1.33% (11)
Maximum % of sales	11.60	20.00	0.21	4.00
Minimum % of sales	0	0	0	0

Numbers in parentheses represent the number of valid answers.

Source: Research "Behavior of Slovene companies and strategies of entry into markets of former Yugoslavia", 2001.

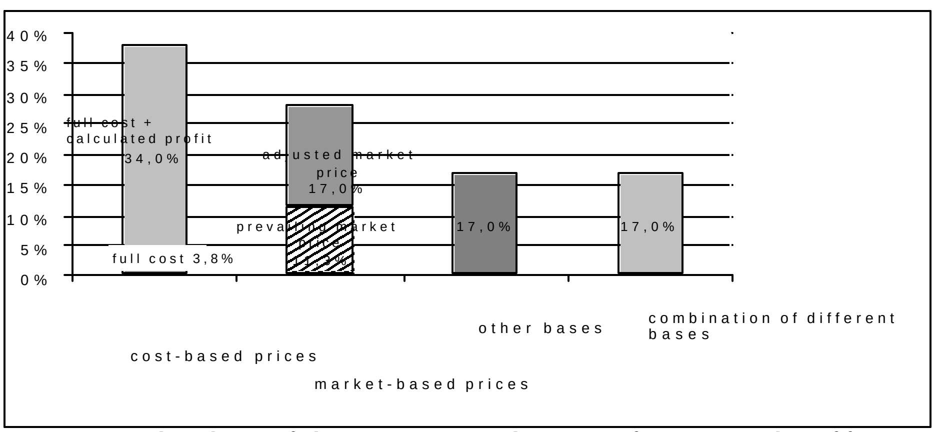
Results in table 8 show that Slovene companies are not overly dependent upon their sales to subsidiaries. The largest share of sales is related to subsidiaries in Croatia and Bosnia where Slovene companies realize most sales on markets of former Yugoslavia.

Companies can choose between different bases for determination of transfer prices. The basis can be cost or prevailing market prices, but other methods such as negotiated prices are also known. Use of prevailing or adjusted market price [i.e. prevailing price reduced by sales-related costs] encourages competitive behavior of subsidiaries. If transfer prices lead to competitive conditions within the firm, unadjusted profit measures can be used in performance evaluation. Striving for minimization of world taxes paid, multinational companies often use transfer prices as a tool for distribution of profit from countries with higher tax rates to those with lower rates. In such case, when transfer prices are not based on market prices, influence of such "manipulated" transfer prices should be excluded from performance evaluation. Conflict of interest between Mother Company and subsidiaries can also be reduced by taking effects of transfer prices into consideration in the evaluation process.

In contrast to factors that are only uncontrollable for the management, influence of transfer prices should be excluded from both, subsidiary and management performance measures! If this is not done, a subsidiary, that operates in a country with a high tax rate and operates with a loss due to manipulated transfer prices, will be evaluated as unsuccessful. Such evaluation will give an unfavorable sign for future investment decisions. Such [unadjusted] performance evaluation measures do not take into consideration additional profit that was gained by other subsidiaries and/or mother company. The next hypothesis is therefore:

If transfer prices between Mother Company and its subsidiaries on markets of former Yugoslavia are not based on market prices, effects of such transfer prices are excluded from performance evaluation of subsidiaries and their management.

Slovene companies use very diverse bases for determination of international transfer prices [figure 3]. Transfer prices on basis of cost prevail and are used by 38 % of companies [majority of the companies that use costs in calculation of transfer prices set them at level of full cost increased by calculative profit, whereas minority sets these prices at level of full cost]. A high number of companies [28 %] use market prices as base for transfer price determination. Adjusted market prices are used more frequently than unadjusted, which means that companies are aware of the fact that selling within the company is "cheaper" than selling on the market. 17 % of companies use other bases [negotiated prices or mathematically calculated prices] and remaining 17 % use a combination of different transfer price bases.



Source: Research "Behavior of Slovene companies and strategies of entry into markets of former Yugoslavia", 2001.

FIGURE 3: FREQUENCY OF DIFFERENT TRANSFER PRICE METHODS USED TO EVALUATE TRANSFERS FROM SLOVENE MOTHER COMPANIES TO THEIR FOREIGN SUBSIDIARIES

Our next question was whether [in accordance to theoretical recommendations] Slovene companies eliminate impact of transfer prices on profit if these are not set at level of prevailing market prices. There are a number of possibilities how to eliminate this effect. Three such options were listed and we asked the managers which one [if any] they used:

1) dual accounting [one set for external and second set for internal reporting]
2) consideration of transfer price effects in budgeting process [the subsidiary can be evaluated as successful although it is operating with loss as long as this loss is a consequence of transfer prices and has been projected in the budget]
3) approximation of transfer prices to prevailing market prices

Companies that set transfer prices at level of market prices do not need to carry out any adjustments in evaluation process. These companies, according to our expectations, answered that no adjustments in evaluation process were made. On the other hand, effects of transfer prices are not dealt with appropriately in companies in which cost and other bases are used in transfer pricing decisions. Effects are not being eliminated in evaluation process, which can lead to taking sub-optimal investment decisions and decrease motivation of local managers. 81 % of these companies do not use dual accounting nor consider transfer price effects in budgeting process. Among 16 companies that use such transfer pricing bases, only one uses dual accounting and only 2 companies consider transfer price effects in the budgeting process.

Conclusion

Independence of Slovenia and related economic and political changes have to a great extent altered the role of accounting information for decision-making in Slovene companies. The business environment of Slovene companies became riskier than it was before transition into market economy. Such environment requires flexible organization structures and fast decision-making which is only possible if appropriate information base for decision-making exists. Accounting information is an important part of information that management needs to decrease business risks and take appropriate decisions.

The main goal of this article was to study to what extent Slovene companies use accounting information to control their operations on markets of former Yugoslavia. Our main supposition was that such information was not adequately used. Markets of former Yugoslavia are interesting to Slovene companies for geographic proximity and historic relations. The research showed that majority of companies are already present on these markets and that they gradually proceed to higher internationalization levels. In the first part of the analysis, all companies that are present on markets of former Yugoslavia were studied. In the second part, we focused on companies that operate through subsidiaries. The first part of analysis focused on how increased dependence upon markets of former Yugoslavia increased importance of accounting information related to:

1) determination of prices
2) measures used to achieve financial discipline and
3) evaluation of operations.

The study showed that majority of companies set their prices at level of full cost plus calculative profit. The comparison to prices set on the EU markets proved that higher prices are reached on markets of former Yugoslavia. Recognition of trademarks is one of the most important factors that allow for such selling price difference. The results did not prove our hypothesis that companies that were more dependent upon a particular market set prices at "cost plus" level more frequently. There are at least two possible reasons for that: 1) the pricing policy is not well established or 2) dependence of some companies is already too high for an independent pricing policy.

Increased dependence upon particular markets [customers] leads to increased importance of accounting information to ensure financial discipline. Among different measures, used to ensure adequate financial discipline, Slovene managers prefer legal charges, followed by complete suspension of supplies and decreased supplies. They do not find reporting bad experience to other companies particularly important. This leads to conclusion that Slovene companies do not share risks related to operations on markets of former Yugoslavia. The research did not show any characteristic relationship between dependence upon particular markets [buyers] and measures used to ensure financial discipline. In contrast to expectations, the results showed that as level of sales increases, financial discipline measures are used less frequently. This conclusion can also be related to the previous finding, regarding increased dependence upon individual buyers.

Among performance evaluation measures, Slovene companies find paid realization most important, followed by contribution margin and profit. Level of sales was not found very important. Importance of paid realization derives from awareness of financial discipline related risks. Another finding was that importance of contribution margin increases with increased sales on these markets. This can have positive effects on one hand, because increasing contribution margin results in higher profits. But on the other hand it can be "dangerous" for long-term success if the company satisfies itself with covering variable costs only [7].

In the second part of our analysis we studied if:

1) establishing foreign subsidiaries is related to perception of high custom duties
2) operations through subsidiaries increase financial discipline
3) evaluation of manager's performance is distinguished from performance of subsidiary as organization unit and
4) effects of transfer prices are appropriately considered in performance evaluation process.

Slovene managers estimated that custom duties are highest in Yugoslavia and that they represent an important entry cost to this market. On other three markets, these are not considered as important. An interesting finding was that companies, which operate through subsidiaries, perceive higher entry costs on all four markets. This leads to conclusion that this was one of the reasons for establishment of subsidiaries.

Results show that the wish to increase financial discipline is not one of the main reasons for establishing foreign subsidiaries. The expected relationship, i.e. companies with foreign subsidiaries achieve higher level of financial discipline, measured with total write-offs, was only found in case of Yugoslavia and FYROM. On these two markets there were no write-offs, but this is mostly consequence of the fact that five out of six companies that operate through subsidiaries in Yugoslavia requested prepayment for purchases.

Performance evaluation measures of managers must be based on controllable factors. We studied whether uncontrollable costs such as interests, allocated indirect costs, foreign exchange gains/losses and licensing costs, were eliminated from calculation of profit, used to evaluate manager's performance. As it turned out, majority of companies use the same profit to evaluate performance of both, subsidiaries and their management. Performance evaluation system, which does not distinguish between controllable and uncontrollable factors, results in sub-optimal decisions related to investment decisions and management's motivation.

Slovene companies use different bases to determine international transfer prices. These are most frequently set at level of cost or market prices. Of major concern is the fact that majority of companies do not take effects of transfer prices in consideration in performance evaluation process. Three possible consequences are inaccurate insight in performance of subsidiaries and management, taking sub-optimal investment decisions and decreased motivation.

References

Contact the Author for a list of References.

Problems of Implementing International Accounting Standards in a Transition Economy: A Case Study of Russia

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Abstract

In 2002, the Russian Prime Minister announced that all Russian companies and banks must prepare their financial statements in accordance with IAS starting January 1, 2004. Implementing that decision will not be easy, for a variety of reasons. Not all IAS have been translated into Russian. Many Russian accountants are not sufficiently familiar with IAS to implement them. Some Russian universities have only recently started teaching IAS and the continuing education programs of the various Russian accounting associations are not yet prepared to offer comprehensive courses on IAS. Current Russian accounting standards conflict with IAS in several important ways and these conflicts will not be resolved in the near future. This paper reviews the literature on this subject and incorporates the results of interviews conducted of Russian accounting firms, enterprises and university professors in July and August 2003.

Introduction

As transition economies go through the process of shedding their centrally planned accounting model and replacing it with a market oriented model such as IAS they face a number of problems. Very few people know the new rules, since IAS must first be translated into their language. Accountants who can read IAS in the original English have a competitive advantage in this regard, but trying to fully exploit this advantage may be frustrating if potential clients or employers do not place much value on IAS.

There is also an inertia barrier to overcome. It is difficult to change the status quo. Accountants and managers who have been using the old system for 20 or 30 years do not want to change because they feel comfortable with the system they learned in school or on the job when they were young. Those individuals also happen to be the people who are now in charge of enterprises and accounting departments, so their approval must be had before any new system can be adopted and implemented.

A number of countries that have started this conversion process have experienced similar problems. No one knows the new rules but there is nowhere to go to take classes to learn the new rules because no one can be found to teach the new knowledge. Most universities do not have qualified professors and most accounting firms do not have anyone who has been trained in the new rules. Yet the governments in these countries often pass laws with deadlines, stating that the new rules must be adopted by some certain date.

What results when this happens is that the new rules cannot be implemented according to the government's schedule because nobody knows how to implement them. A new set of problems result from this top-down approach to accounting reform. Various ways have been tried to alleviate or solve the problems that result from adopting new accounting rules. Some have worked better than others. This paper examines the Russian case, which is still in the process of transformation.

Review of the Literature

Much has been written about International Accounting Standards (IAS), International Standards on Auditing (ISA), accounting harmonization, accounting education and accounting reform in transition economies in recent years. A few books and articles have focused on accounting reform in Russia.

The classic book in the sub field of accounting reform in Russia is by Enthoven [8]. This book discusses the Russian accounting system, management accounting, auditing, taxation and accounting education. A few years before that, Enthoven [9] published a book on doing business in Russia and other former Soviet republics that dealt with accounting issues. This latter book was very popular among accounting practitioners who were doing business in the former Soviet Union, since it was one of the few major sources of accounting information on Russia at the time it was published.

Bailey [2] published a long historical study of Russian accounting going back to the thirteenth century. Shama and McMahan [57] discuss the historical development of accounting in Russia from Tsarist times to communism and also how perestroika will change the nature of accounting in Russia and other East European countries. Motyka [44] discusses the impact of Western Europe on accounting development in tsarist Russia prior to 1800. Lebow and Tondkar [33] discuss the development of accounting in the Soviet Union and its effectiveness. Two decades before that, Campbell [3] published a book containing a series of essays on Soviet accounting problems. Campbell [4] also did a long and detailed study of depreciation under the Soviet accounting system. Horwitz [23] discusses some of the philosophical and historical literature on accounting in a socialist regime and focuses his attention on depreciation and cost.

An early study by Mills and Brown [39] discusses how shifting from a production model to a profitability accounting model would help Soviet enterprise managers make decisions that would increase the efficiency of their firms and help them to better allocate resources. In a similar vein, Thornton [59] discusses changes in the way the Soviets accounted for factor costs over a twenty-five year period. A study by Scott [55] states that Soviet accounting after the 1965 reforms started to place more emphasis on enterprise profitability, which helped move the Soviet economy closer to a Western market model.

Other authors have also touched on this theme. Horwitz [22] discussed the effect that decentralization has on the management accounting control system. Chastain [5] described how the Soviet accounting system was not able to keep up with the needs of enterprise managers. He also assesses the implications of that inability for the accounting profession.

Gorlick has done several studies on the Soviet accounting system. In one study he discusses the historical development and problems of uniform accounting [17]. In another he discusses planning and control [18]. In an earlier study he discussed the difference in accounting measurements between the Soviet Union and the United States and the advantages and disadvantages of their profitability measurements [17].

Richard [49] wrote a book chapter that discussed communist accounting systems in Eastern Europe in general and in the Soviet Union in particular. Garrod and McLeay [16] edited a book on accounting in transition economies, which provides a good introduction to many of the issues involved in attempting to convert the accounting system from a central planning model to a market model. In one of the chapters in that book, Jaruga [27] describes the changing accounting function in socialist countries, which is now mainly of historical interest.

Turk and Garrod [61] discuss the lessons Slovenia learned when it began the process of changing to International Accounting Standards. The Slovenian experience is not unlike the Russian experience in many ways. Preobragenskaya and McGee did research on the relationship between IAS and foreign direct investment in Russia [46] and on the state of auditing in Russia [47]. Their FDI study concluded that the lack of credibility of Russian financial statements was hampering inflows of foreign capital. Their audit study found that the state of auditing in Russia is not yet up to western standards.

A few studies have been made on accounting education in Eastern Europe or the former Soviet Union. According to one scholar, Houghton Mifflin’s 1300-page Principles of Accounting was the first Western accounting text sold in the Soviet Union [7]. It was translated and distributed by Finansy I Statistika, Moscow’s government owned publisher. Kobrack and Feldman [28] speculated whether the reform process in the Soviet economy could create a new market for accounting textbooks. McGee has written about educating accounting professors in Bosnia & Herzegovina [37] and reforming accounting education in Armenia [38].

There are several sources of information on recent developments in accounting reform in Russia. The International Center for Accounting Reform in Moscow [www.icar.ru/] publishes the ICAR Newsletter [24]. The World Bank publishes Transition Newsletter [60], which gives current information about various aspects of market reforms in transition economies, including accounting reform in Russia. The Russian websites of the Big-Four accounting firms also have current information and, in some cases, publications.

The Deloitte & Touche Russian website [www.deloitte.ru] has an e-library link that contains a variety of items on various aspects of doing business in Russia. It has a Doing Business in Russia Online Guide, which includes much information on accounting and tax topics. It has several newsletters that address accounting, tax and legislative issues on various countries, including Russia. Russia - Legislative News [52] is a monthly newsletter that contains accounting and tax items. Legislative Tracking [34] is a daily publication that keeps readers abreast of Russian pending legislation.

Ernst & Young publishes An EYe on Russia [1], a monthly newsletter on current business, accounting and tax issues. It also has a Russian Legislation website [53] that contains downloadable documents on Russian accounting, tax and related legislation that have been translated into English.

The KPMG Russian website [www.kpmg.ru] has several good publications, including Doing Business in Russia [29] and Russia – Tax Overview [30]. It also has the GAAP 2001 [14] and 2002 [13] studies.

The PricewaterhouseCoopers website [www.pwcglobal.com/ru] has several publications pertaining to Russia, including Doing Business in the Russian Federation [48]. There are also a number of short articles by PWC partners and others on various aspects of accounting reform in Russia, including an excellent article by Leonid Schneidman [54] on the long road to IAS adoption. The PWC site also has the GAAP reports for 2002 [13], 2001 [14] and 2000 [15] available for downloading in several languages.

Some publications have compared the accounting standards in various countries to IAS. The most thorough study is GAAP 2001 [14], a joint publication of several large international accounting firms, which makes comparisons for 62 countries, including Russia. Several of the Big-Four accounting firm websites have a link to this study. The International Forum of Accountancy Development website [www.ifad.net] has published this study in interactive format. There is also a GAAP Comparison 2000 study [15] that provides comparisons for 52 countries and a small 2002 update titled GAAP 2002 Convergence [13] that provides data on 59 countries. Street [58] (2002) has written a summary of the GAAP 2001 study [14].

The internet also has information on corporate governance in Russia. One good source is the Independent Directors Association website [www.independentdirector.ru], which contains much up to date information on corporate governance in Russia. It publishes Independent Director, a quarterly review and has also published The Code of Conduct of Independent Directors [6] and The Independent Directors Association Charter [26], both of which are published in the Spring 2003 issue. The Organisation for Economic Cooperation and Development (OECD) website also has current and relevant information on corporate governance in Russia [www.oecd.org]. The Russian Code of Corporate Conduct can be accessed from several websites, including the Deloitte & Touche Russian website [www.deloitte.ru].

Methodology

The first stage in the preparation of this paper was a thorough review of the literature on accounting reform in general and accounting reform in Russia and other transition economies in particular, with special attention being paid to the literature that discussed the adoption and implementation of IAS. As the literature was being reviewed, the authors started compiling a tentative list of questions to ask Russian accounting experts on various aspects of accounting reform in Russia. This list was sent to the individuals to be interviewed several weeks prior to the interviews.

After the list of questions was compiled, the next step was to identify and contact individuals who were experts in some aspect of the present state of Russian accounting, which was done through a combination of website searches, telephone calls in both Russia and the United States and e-mail communications. It was difficult to contact some individuals, especially at Russian universities, because they were away on summer holiday. However, a sufficient number of experts with diverse backgrounds on various aspects of accounting reform in Russia were able to be contacted and interviewed to make the project worthwhile. Once experts were identified, initial contact was made and interviews were scheduled. On-site interviews took place during July and August 2003 in St. Petersburg, Moscow and Omsk. Telephone interviews were also conducted with individuals located in Washington, DC and Geneva, Switzerland. Individuals from the following institutions participated in the on-site interviews:

Deloitte & Touche, Moscow office [www.deloitte.ru]
KPMG, Moscow office [www.kpmg.ru]
KPMG, St. Petersburg office [www.kpmg.ru]
PricewaterhouseCoopers, Moscow office [www.pwcglobal.com/ru]
Ajour, a Russian auditing and consulting firm, Moscow [www.ajour.ru]
PKF (MKD), a Russian audit and consulting firm, St. Petersburg office [www.mcd-pkf.com]
Independent Directors Association, Moscow [www.independentdirector.ru]
MDM Group, Moscow [www.mdmgroup.ru]
St. Petersburg State Polytechnical University [www.spbstu.ru]
St. Petersburg State Railway University (a.k.a. Petersburg State Transport University) [www.pgups.ru]
Timiryazev Agricultural Academy, Moscow [www.timacad.ru]
Hock Accountancy Training, Moscow office [www.hocktraining.com]
Omsk State University [www.omsu.omskreg.ru]
Omsk State Institute of Service [www.omsk.net.ru/education/vuz/servis/main.htm]

The information gathered from these interviews was combined with information that was already published and available. While much of the information gathered during the course of the interviews confirmed what the existing literature already said, much new information was gathered that filled in the gaps in the existing literature and extended and updated prior studies in several important ways.

Problems of Implementing IAS

Accounting in Russia

Accounting has a long history in Russia [2, 57], going back at least to the thirteenth century, through the time of the tsars and through the communist era. The Russian accounting system started shifting away from the centrally planned, socialist model as early as the 1960s [27, 39, 55, 59]. The pace accelerated with perestroika and the collapse of the Soviet Union, which began in the late 1980s. Some scholars have gone on record as saying the reason for the collapse of the Soviet Union was because of the inability to allocate resources efficiently under a socialist accounting system [50, 56]. Ludwig von Mises, an Austrian scholar who later taught at New York University, predicted the collapse as early as the 1920s [40, 41, 42, 43]. His prediction sparked the socialist calculation debate of the 1930s [20, 21, 31, 32, 35, 36]. Polanyi [45] agreed with Mises that the problem of economic calculation is insoluble in a centrally planned economy but proposed to solve the problem by means of "a functionally organized socialist transition-economy."

Whatever the reason(s) for the collapse of the Soviet Union, there has been a worldwide movement on the part of formerly centrally planned economies to move away from the top-down, centrally planned accounting model and toward a bottom-up market model. Russia started to make the transition by deciding to adopt and implement IAS. Although Russia chose to adopt and implement IAS several years ago, there are still some glitches in the system.

Until recently, deducting the cost of an IAS audit was not allowed by the Russian tax code [10], which took some of the incentive away from having such an audit. Russian accountants and auditors are not sufficiently well versed in IAS to implement them, with a few exceptions. There is a widespread perception on the part of accountants who work for the large international accounting firms that none of the Russian accounting firms, even the biggest ones, are able to provide high quality serving regarding IAS. The large international accounting firms, mostly the Big-Four, have rushed in to fill the gap to provide the services and expertise that the local Russian firms cannot provide. This capturing of market share by the big firms has caused some resentment on the part of the smaller Russian firms. It has also given some Russian accounting firms an inferiority complex, since they know they do not have the resources or expertise to compete against the international firms. Russian accounting firms have lost some large clients to the Big-Four. However, some of their big clients later returned, partly because of cost considerations.

Russian accountants and auditors who were trained under the old system need to learn the new system and many of them have not. Some of them, especially the older ones, are actively resisting the change. Some Russian accountants and professors, even at the top, insist that they use or teach IAS, even though they have never read them. There is the widespread perception that Russian Accounting Standards (RAS) either are the same as IAS or are just as good. In fact, there are major differences. RAS are more form over substance, whereas IAS are more substance over form.

There is also the perception that IAS are not needed, either because the RAS are just as good as IAS or because there is no demand for IAS. There is a grain of truth to the lack of demand argument. Until a few years ago, the only reason most firms prepared financial statements was to provide information to the tax authorities. Some firms still prepare financial statements just for the tax authorities. However, the trend now is away from having a monopsony (single user) of accounting information, especially with the large Russian firms, since they need to go to the international capital markets for funds to expand or stay afloat. Foreign investors demand to see financial statements prepared using either IAS or GAAP as a condition of talking seriously about investing in a Russian company.

Although the trend is to place more emphasis on the needs of shareholders and potential investors and less on the needs of tax authorities, not all Russian accountants and managers feel this way. Most accountants who work for the big international accounting firms, and many of their clients, now recognize the goal of financial statements is to provide information to shareholders, not the tax authorities. This change in attitude and perception started to take place around 1999 or 2000.

This change in attitude has not yet filtered down to the smaller firms and enterprises. Although the big accounting firms and an increasing number of large enterprises now recognize that the main audience for the financial statements they prepare are shareholders, the smaller Russian companies still think that accounting information is only for the tax authorities. Some CEOs at larger companies still think this way.

This attitude is reinforced by the Russian tax authorities themselves, who often could not care less to see any financial statements based on IAS. The Russian tax rules are different from IAS, so why bother to look at financial statements that are prepared using IAS? They want to look only at statements prepared using RAS. One of the partners interviewed at one of the international accounting firms said he was tired of having to sign off on two sets of financial statements, one based on RAS and one based on either IAS or GAAP. He longed for the day when he would need to sign off on only one set of statements. He also confided that such a day is likely far off, since statutory accounting still requires the use of RAS and this rule is unlikely to change any time soon.

Not all Russian enterprises that are trying to attract foreign capital are using IAS. Some of them are using U.S. GAAP. One of the deciding factors that enters into the decision to use one or the other set of internationally recognized financial reporting standards has to do with which capital market the enterprise wants to tap into. If they are targeting the United States capital market, they often decide to use U.S. GAAP. Those who decide to tap into the European capital market often choose IAS. Russian enterprises used to prefer U.S. GAAP to IAS because they wanted to list their shares in New York. The trend is now toward IAS because of the Enron and Arthur Andersen scandals. However, not all firms are shifting to IAS. The subsidiaries of the many U.S. firms in Russia prefer GAAP, so it appears that there will be a need for GAAP-trained accountants for the foreseeable future.

The interviews revealed that there is a bit of standards shopping going on on the part of some Russian enterprises. In one case, an enterprise would have had a multimillion deferred tax liability using one set of standards, whereas their tax liability using the other set of standards would have been zero. One set of rules would have treated the book tax difference as a permanent difference whereas the other standards would have treated the difference as a timing difference, and thus subject to deferral. Not surprisingly, the enterprise chose to use the set of standards that did not result in a tax liability.

Some Russian audit firms will agree to sign anything, including an audit report, lest they lose a client. Or at least that is the perception. Unfortunately, there may be some truth to this perception. Russian business culture is different than Western business culture in this respect. Three generations of communist governments and the accompanying corruption that went with it have made people cynical. Many people simply do not believe that financial statements signed by a Russian audit firm are as credible as statements signed by a Western audit firm [51].

One solution to this dilemma would be to establish a strong private sector accounting organization like the American Institute of Certified Public Accountants (AICPA) [www.aicpa.org] or one of its British counterparts that is capable of policing its members and giving much needed moral support to the Russian audit firms that do not want to give into the pressure to sign audit opinions when financial statements are not of sufficiently high quality. This solution was proposed both by the Russian firms that were interviewed and by some members of the Big-Four. Unfortunately, no such private sector accounting organization currently exists and none are on the horizon. There are a number of small, politically weak accounting organizations, but they do not have the authority, power or incentive to do the policing job or to provide the moral authority needed to support the honest Russian audit firms that want to do the right thing.

It is encouraging that Russian accountants have identified the problem and have a good idea of where the solution might lie. The next step is to find a way to achieve the desired result. That will not be easy, at least for the immediate future, since the Russian accounting profession, in the Western sense of that term, is in its infancy stage. There is no recent history of private sector institution building in Russia and the other former communist countries. The only institution was the State, and in some cases, the church. Private sector institutions will need to be created and grow in size and strength, and that process will take time, perhaps a generation or more.

Some of the individuals interviewed pointed out that part of the problem is that the professional accounting organizations that do exist have a bias in favor of the status quo. So do Russian bureaucrats. Milton and Rose Friedman discussed this inertia problem in theoretical terms several years ago [12]. One of the interviewees said that the people in these accounting organizations do not know anything about IAS, that they do not have the required skills and that changing to IAS could put them out of a job.

Outside help is available for strengthening these private sector accounting associations. George Soros and his various foundations have recognized the need to build and strengthen private institutions and have allocated millions of dollars toward this goal. The various USAID and Tacis accounting reform projects include an institution building component in their projects. The problem with some of these institution building projects is that they turn out to be top-down. The local accountants and existing accounting organizations need to be convinced that they need to build such institutions. The institution building process would go faster and smoother and would be more successful if the process were demand driven, with the demand emanating from the grass roots rather than from some international organization that offers to drop money and consultants on the problem.

Another structural problem with Russian accounting is the Russian mindset. Under the old centrally planned system, accountants were really bookkeepers. They didn’t have to make decisions. Their job was just to make journal entries. There was no such thing as exercising professional judgment. Where a decision had to be made, their solution was to look for some rule that told them what to do. The new rules, whether IAS or GAAP, require the exercise of professional judgment and many Russian accountants do not feel comfortable. They would prefer to find some rule in a book that instructs them on how to do everything and they resist adopting the new rules. This structural bump in the road to the adoption and implementation of market based accounting rules will be worn down with time, but it will take perhaps a generation or more before Russian accountants think the same way as Western accountants in regard to this approach to decision making.

Several government ministries are involved in accounting reform. Unfortunately, they do not always think the same way. In fact, their approaches to accounting reform are drastically different. The Ministry of Economic Development and Trade is strong on policy formation but does not have much power over policy implementation. Its approach is bottom-up. The Finance Ministry, on the other hand, prefers a top-down approach, similar in structure to the old centrally planned Soviet system. Westerners feel more comfortable dealing with the Ministry of Economic Development and Trade, since Western accountants also prefer a bottom-up approach.

However, these two ministries are not the only government agencies that are involved in accounting reform. The Russian Securities Commission and the Central Bank also play a role. In 2002 the Association of Russian Entrepreneurs also became involved in accounting reform. But no one is in charge. There is no leadership. There is no central direction to accounting reform. It is almost like all of these institutions are groping in the dark. While some government ministries demonstrate an interest in accounting reform, they are unable to answer questions because of a lack of expertise.

There is no force driving accounting reform, from an organizational perspective. No organization wants to protect both accounting and the public interest. The pressure to reform accounting in Russia is coming from the market. Russian enterprises that want to raise capital, either by debt or equity financing, need to have statements prepared either according to IAS or GAAP. Potential investors demand it. That is the factor that is causing the change, not some government bureaucracy that dictates policy and rules from on high.

Most of the largest companies, like Gasprom, Aeroflot, metallurgical plants, electricity plants, etc., including 80 percent of the biggest companies and 95 percent of banks prepare financial statements based either on IAS or U.S. GAAP. The real driver of accounting reform is the large companies. They are doing it in spite of government inaction. The market is solving the problem without government.

IAS in Russia

Accounting is part of the legislative system. That is a problem because Russia will never have true IAS if government has to legislate it. There will always be a lag and style and language problems. The original plan by the Russian Finance Ministry in 1998 was to adopt all IAS by 2000. That did not happen. The new target for full adoption and implementation is 2004, at least in the case of banks and publicly traded companies. However, that target is also unlikely to be met. In fact, not a single accountant interviewed thought that IAS would be fully adopted and implemented by 2004. One accountant estimated that full implementation would take ten years.

Even though Russia is in the process of adopting IAS, it has not adopted all of the international accounting standards, and it has no immediate plans to adopt the standards it has not already adopted. It has not adopted the standards on impairment, financial instruments or hyperinflation. There are good reasons for not adopting each of these standards.

In the case of the standard on impairment, many Russian companies and their accountants do not want to apply the impairment rules because many companies have assets that are overvalued. Applying the impairment standard would cause the asset side of the balance sheet to shrink, considerably in many cases, and they do not want that to happen. In extreme cases, a company that appears healthy could appear to be insolvent if the impairment rules were applied. This hesitancy is not unique to Russia. The same situation exists in Republika Srpska, the Serbian part of Bosnia, and in other formerly centrally planned economies.

Perhaps the main reason why the standard on financial instruments has not been adopted is lack of demand. Very few Russian enterprises use complex financial instruments, and the ones that do are already applying the IAS or U.S. GAAP on this topic. Also, this standard is difficult to understand and many Russian accountants are not eager to make the effort to learn a standard that they probably will not use in the foreseeable future.

The IAS on hyperinflation is not needed, or at least that is the perception of many Russian accountants, because Russia's inflation rate has fallen below the threshold needed to trigger the hyperinflation standard. Russia's cumulative inflation over the most recent three years has been about 90 percent, and the threshold for using the hyperinflation standard is 100 percent. But the 100 percent test is only one of five items on the IAS list of possibilities. Russian companies do their planning in dollars, not rubles. If the ruble is not being used to make management decisions, a strong argument can be made that the hyperinflation accounting rules should be used even if the inflation rate does not hit the 100 percent minimum threshold.

Another point that could be made about Russia's adoption of IAS is that even the standards that have been adopted may not always be IAS. For example, the IAS on income taxes that Russia adopted is the old version of that standard, not the new one. This fact is known within much of the Russian accounting community but may not be as well known outside of Russia. Another, less well known fact about Russia's adoption of IAS is that the Russian version of the standards that have been adopted are not mere translations of the English language originals. In many cases they are abbreviated, simplified versions of the original English language IAS. RAS tend to be much shorter, more detailed and conceptual. They cover a fraction of the content of IAS. Often the differences between RAS and IAS are not large or important. However, the difference may be substantial, such as in the area of accruals principles.

Many studies have been made that compare RAS to IAS, or that list the Russian accounting standards that are on the same topics as the IAS. The GAAP 2000 [15] and GAAP 2001 [14] studies are perhaps the most famous and most accessible, since they were done by reputable firms and since they are available on the internet in several languages. PricewaterhouseCoopers updated the GAAP 2001 study in its *Doing Business in the Russian Federation* publication [48]. A summary of that update is shown in Table 1. This table compares the rules that were in force on March 15, 2003.

TABLE 1. DIFFERENCES BETWEEN RUSSIAN ACCOUNTING STANDARDS AND INTERNATIONAL ACCOUNTING STANDARDS

Russian accounting may differ from that required by IAS because of the absence of specific Russian rules on recognition and measurement in the following areas:	
- the classification of business combinations between acquisitions and unitings of interest	IAS 22.8
- provisions in the context of business combinations accounted for as acquisitions	IAS 22.31
- consolidation of special purpose entities	SIC 12
- the restatement of financial statements of a company reporting in the currency of a hyperinflationary economy in terms of the measuring unit current as of the balance sheet date	IAS 29.8
- the translation of the financial statements of hyperinflationary subsidiaries	IAS 21.36
- the treatment of accumulated deferred exchange differences on disposal of a foreign entity	IAS 21.37
- derecognition of financial assets	IAS 39.35
- the recognition of operating lease incentives	IAS 17.25; SIC 15
- accounting for defined benefit pension plans and some other types of employee benefits	IAS 19.52
- accounting for an issuer's financial instruments	IAS 32.18/23
- hedge accounting for derivatives	IAS 39.142
- the treatment of exchange differences resulting from severe devaluation or depreciation of a currency	IAS 21.21; SIC 11
There are no specific rules requiring disclosures of:	
- a primary statement of changes in equity	IAS 1.7
- a primary statement of cash flows; and the notion and definition of cash equivalents, and detailed guidance on the preparation of cash flow statements	IAS 7
- the FIFO or current cost of inventories valued on a LIFO basis	IAS 2.36
- the fair values of financial assets and liabilities	IAS 32.77
- the fair values of investment properties	IAS 40.69
- related parties information except by certain reporting companies with a specific legal form (joint stock companies); the definition of a related party is a narrower one, based on legislation	IAS 24.1-4
- certain segment information (e.g. a reconciliation between the information by reportable segment and the aggregated information in financial statements, significant non-cash expenses, other than depreciation and amortization, that were included in segment expense and, therefore, deducted in measuring segment result – for each reportable segment)	IAS 14.61/67
There are inconsistencies between Russian rules and IAS that could lead to differences for many enterprises in certain areas. Under Russian rules:	
- goodwill is calculated by reference to the book values of acquired net assets	IAS 22.40
- proportionate consolidation may be used for subsidiaries in which the parent has 50 percent or less of the voting power	IAS 27.15
- revaluation of property, plant and equipment is allowed but gives different results than IAS and need not be kept up-to-date	IAS 16.29
- the useful life of property, plant and equipment is usually determined using periods prescribed by the government for tax purposes, which are longer than those for which the assets are expected to be used, but in practice the management of a company sets the periods in the accounting policy	IAS 16.6/41
- if investment properties are revalued, they are still depreciated	IAS 40.27
- if investment properties are revalued, the gains and losses are not required to be taken to the income statement	IAS 40.28
- finance leases are generally defined in legal terms and the right of capitalization is given to a lessor or a lessee by the Contract	IAS 17.3/12.28
- lessors recognize finance lease income differently	IAS 17.30

- the completed contract method can be used for the recognition of revenues on construction contracts when the outcome of a construction contract can be estimated reliably	IAS 11.22
- trading, available-for-sale and derivative financial assets are not recognized at fair value	IAS 39.69
- trading and derivative liabilities are not recognized at fair value	IAS 39.93
- any financial investments are not required to be carried at fair value	IAS 39
- provisions can be established more widely or less widely than under IAS, and there is no requirement for discounting	IAS 37.14/45
- own (treasury) shares are shown as assets	SIC 16
- classification of cash flows between investing and financing activities in the cash flow statement may be different from IAS	IAS 7.6/16/17
- cash flow statements reconcile to cash rather than to cash and cash equivalents	IAS 7.45
- the correction of fundamental errors is included in the determination of the net profit or loss for the reporting period, but separate disclosure and pro-forma restated comparative information are not required	IAS 8.34/38
- revenue recognition rules do not differentiate between exchanges of goods of similar nature and value and exchanges of dissimilar goods, and do not discuss adjustment for the amount of cash or cash equivalents transferred in exchanges for dissimilar goods	IAS 18.12; IAS 16.21/22
- the definition of extraordinary items is broader	IAS 8.6/12
In certain enterprises, these other issues could lead to differences from IAS:	
- some parent companies do not prepare consolidated financial statements	IAS 27.7/11
- in the definition of control, it is not required that the ability to govern decision-making be accompanied by the objective of obtaining benefits from the entity's activities	IAS 27.6
- certain subsidiaries may be excluded from consolidation beyond those referred to in IAS	IAS 27.13
- a subsidiary that is a bank may be excluded from consolidation if it is dissimilar from the rest of the group	IAS 27.14
- certain set-up costs that have been paid by a company's founder can be capitalized	IAS 38.57
- internally generated brands and similar items can be capitalized if the enterprise has an exclusive legal right	IAS 38.51
- inventories are generally carried at cost rather than at the lower of cost and net realizable value; this is often not an important difference because of inflation	IAS 2.6
- the realizable value of inventories can be measured without deduction of selling costs	IAS 2.6
- certain overheads in addition to those related to production can be capitalized	IAS 2.7

Source: PricewaterhouseCoopers: Doing Business in the Russian Federation (2003)

These studies list the differences between RAS and IAS. The problem with these lists, which is not revealed in any of these publications but was discovered during the course of the interviews, is that these compiled lists of differences do not include mention of any RAS that is an abbreviated, simplified version of the English language IAS. For example, if the English version of IAS 99 is 80 pages long and the RAS on that topic is 10 pages long, IAS 99 is not included in the list of differences, even though the Russian standard is clearly not identical to the international standard. Thus, these comparative lists are deceptive because they do not reflect the true and total differences between RAS and IAS. The list is relatively short, and many items on the list are for items that are inconsequential, leading an unsophisticated reader to believe that the differences between RAS and IAS are small, when in fact the differences can be quite large for certain standards.

Another problem with making comparisons between RAS and IAS or GAAP is historical. IAS has a historical base. International standards are based on more than 100 years of Anglo accounting evolution. Because of that, much is understood but not stated. The Russian accounting system has no such long history. So making such lists and comparisons is dangerous, in the sense that it can be misleading.

There are differences of interpretation and emphasis even within the Western market economies that have adopted IAS or some similar set of rules. For example, a German accountant and a British accountant could interpret the same rule differently for cultural reasons. Germans are more conservative and would tend to make provisions that British accountants might not make. Germans provide for everything; Russians provide for nothing.

Some of the individuals interviewed stressed the point that RAS will never be identical to IAS. They will never be a mere translation, even if every word in every IAS is translated directly into Russian. That is because Russian culture and Russian thought processes come into play. The way Russian accountants interpret the rules will always be different than the way an English accountant will interpret the language contained in the various international standards.

One reason for the differing interpretations is because of conflicts in definitions. IAS contains definitions for a great many terms. So does the Russian Civil Code. But the Civil Code definitions are often different from the IAS definitions. What is a Russian accountant to do when confronted with these differences? These differences have caused arguments with clients in the past. These definitional problems will not go away in the near future if for no other reason than because the Duma has more important things to do than expend a lot of effort harmonizing accounting definitions with the already existing Civil Code definitions. This problem would be nonexistent if the accounting rules were formulated in the private sector, but they are not.

Another reason why RAS will never be identical to IAS is because there is a timing lag between the time a new IAS is issued in the UK and the time that new IAS is translated into Russian and adopted as part of the Russian accounting rules. This lag could be overcome if the Russian Duma (Parliament) made it a rule that all new international accounting standards will automatically and immediately become part of the Russian rules. However, the Duma will never make such a rule, for reasons of national pride and sovereignty. So the lag will be permanent, even though there is a theoretical solution that would correct this lag.

The degree to which the Russian accounting community understands IAS depends on several factors. The Russian translation of the original English version of the standards was not available until late 1998. The translation was mediocre, in some respects. Part of the problem was because there were no Russian terms to convey some of the concepts. In other cases, the Russian translators simply used the wrong word or said things in such a way as to make the sentence or phrase unintelligible. In at least one case, the translator left out the word "not," with the result that the Russian version of the standard instructed the reader to do something, when in fact the rule said *not* to do something. These kinds of mistakes and imperfections are to be expected the first time a technical document is translated, especially in cases where no terms exist for some of the words and ideas that need to be translated.

The Russian accountants who cannot read English are limited to reading the Russian translation of IAS. That places them at a competitive disadvantage, for the reasons mentioned above. The Russian translation is mediocre in some places and in other places is downright incorrect. The Russian speaking accountant has no way of knowing how accurate the reading of a particular sentence or paragraph might be, but must rely on what is written because there is no other alternative. Russian accountants who were educated in a university that did not teach IAS have a problem reading IAS in any language because the standards contain concepts that the Russian accountant was never exposed to during the years at the university. Such accountants must learn the new rules as best they can, either by self-study or by attending some lectures or seminars on the various topics.

The interviews revealed that the Big-Four accounting firms have found a way around this translation problem, which gives them another competitive advantage over the local Russian firms. The Big-Four have a tendency to hire people who speak English, and at least one of the Big-Four will not hire anyone who does not speak, read and write English. The accountants who work for these firms refer to the original English version of IAS and do not even read the Russian version, except perhaps as a secondary reference. Thus, they avoid all of the problems that are inherent in relying on the Russian translation.

Another advantage that the Big-Four firms have over their Russian-only brethren is the IAS materials their various affiliate firms have developed over the years. The Big-Four branches in the United States, the UK and elsewhere have, over the years, developed a great deal of reading materials and some case studies that address many of the questions and problems that pop up when accountants try to apply IAS. These materials are available to the employees of the accounting firm and also to their clients. The Big-Four firms also have regularly scheduled educational programs for their employees and clients, whereas the other Russian firms may or may not have such programs.

This wealth of educational material gives the Big-Four accounting firms an additional advantage over their Russian competitors. They can offer their clients an education that most Russian accounting firms cannot compete with. Much of the client training they provide is free. The training that they do charge for is offered at a very reasonable price. One reason for the low price is because many Russian enterprises cannot afford to pay New York or London prices. Another reason has to do with Russian culture. Russians are accustomed to getting free education. They do not see the need to pay high prices for education. This attitude affects the ability of the large accounting firms to charge a price that is high enough to meet their costs.

Another problem with the implementation of IAS that the interviews revealed is that the Russian accounting community operates as a two-tier system. The accountants who work in Moscow, St. Petersburg and a few of the other large cities are more knowledgeable about IAS than the accountants who do not work in the large metropolitan centers. The big city accountants have more and better access to accounting materials and courses that will help them to keep current with recent developments, or even to become familiar with the basics of IAS. Accountants in the outlying regions do not have this kind of resource at their disposal. Perhaps they have internet access, which would enable them to tap into some pertinent information that is available on the net, but even internet access is not as good outside of the big cities as it is within them. However, much of the information available on the internet is useless if the accountant cannot read English, since there is much information available in English that is not available in Russian. Also, the Big-Four accounting firms do not have offices in the smaller Russian cities, so the infrastructure they carried with them to Moscow and St. Petersburg is almost totally absent outside of those two cities.

Another reason why the accountants in the outlying regions are not as knowledgeable about IAS as are the big city accountants is due to differences in demand. Most clients that need statements prepared according to IAS are in Moscow or St. Petersburg. A few big enterprises are scattered around other parts of Russia, mostly in the bigger cities. The accountants who service smaller clients have little or no need to know IAS, so they do not take the time to learn them. The result is a two-tier system where the accountants and the employees who work for their clients know at least something about IAS, whereas their counterparts in the outlying regions know less, or perhaps nothing about IAS.

This situation is unlikely to change soon. Some accountants, and even university professors who live in the regions have never seen the Russian translation of IAS and have not seen any Russian accounting books that discuss IAS.

The drive to adopt and implement IAS is coming more from the market than from the Russian government. Although the government is pushing for adoption and implementation of IAS, the force that is really motivating Russian enterprises to use IAS is the carrot of foreign capital. Foreign investors simply refuse to consider making loans or investing in a Russian company that does not prepare its financial statements using either IAS or GAAP. Russian enterprises are also under pressure from the international investing community to have their statements audited by a large foreign audit firm such as one of the Big-Four. So the process of adopting and implementing IAS is more of a bottom-up system than a top-down system. The market is causing the changes to be made where they need to be made and it is doing it faster and better than what could be accomplished by mere government decrees.

Another interesting facet of Russian accounting that the interviews revealed was how Russian accounting firms and enterprises are dealing with the new disclosure requirements. IAS and GAAP both require much more disclosure than what Russians are accustomed to providing. Many Russian executives and accountants feel uncomfortable providing so much disclosure. Russian culture, even before the communist era, produced a closed mouth society, at least as far as revealing information to bureaucrats, government officials and the general public was concerned [11].

Disclosure is new to the Russians and some of them do not know how to deal with it. Financial statement disclosure is sometimes more detailed than in the West, but the quality is often lower. Russian accountants tend to disclose information that has little or no value. They sometimes report extraneous information because they do not understand what is relevant for disclosure purposes. They do not always know what information is important to potential foreign investors, so they report what they are most familiar with. They provide financial statement ratios, disclose the number of employees, and so forth but sometimes leave out information that foreign investors might want to know. Some Russian financial statements are flooded with information that is of little or no use for investment decision making purposes.

Concluding Comments

As a partner in one of the large international accounting firms stated, the three most important factors that international investors consider are who their partner is, whether the financial statements are transparent and whether the statements were prepared using either IAS or GAAP. Foreign investors are not at all interested in reading statements prepared using RAS, not only because they are not well versed in RAS, but also because they do not believe that the Russian statutory accounting rules provide good accounting information. Accounting reform is an essential ingredient of economic independence.

Then there is the problem of what is called black cash. Not all transactions are recorded. The Russians have devised ingenious ways to evade taxes. Applying IAS or GAAP to a company's books will not solve this problem if some important transactions are never included in the books. President Putin has instituted a low flat corporate (24%) and individual (13%) income tax, which will take away some of the incentive for playing tax evasion games, but tax rates that are low by European standards will not totally end the practice, since tax evasion is seen as not only a way to reduce taxes but also as a game.

Another question is how long it will take the rest of Russia to catch up to Moscow and St. Petersburg, in terms of the level of sophistication of financial reporting and in terms of accounting education. The only thing that can be said for sure is that it will take a long time. The process is market driven. Specific enterprises and regions will catch up as the market demands quality financial information. The speed with which the various regions will approach the Moscow – St. Petersburg standard will depend on whether international investors have an interest in investing in a particular enterprise or region, and on whether that enterprise is interested enough in attracting foreign capital to prepare its financial statements using some internationally accepted standard like IAS or GAAP.

Another structural problem that needs to be overcome is the lack of knowledge of IAS on the part of the clients that retain the services of the large accounting firms. One partner who was interviewed revealed that only two of the accountants at one of the top Russian enterprises had any knowledge of IAS whatsoever. This low level of knowledge makes it more difficult for any accounting firm to provide the proper services. Over time, this problem will shrink in importance, as the accounting firms train their clients and as a new crop of accounting graduates take their places in the accounting departments of these enterprises. But this process takes time.

There was some disagreement as to whether the level of accounting education would improve faster in accounting firms or in universities. The professors who were interviewed in St. Petersburg and Moscow thought that accounting education would improve faster in the universities. The reason they gave is that their professors are also engaged as outside consultants and they bring their knowledge into the classrooms.

But practitioners responded differently to this question. Especially in the case of the large international firms, there was the perception that the materials they provided for instruction and the resources they had to draw upon were of superior quality to those available in universities. Also, it could be mentioned again that the materials the international firms use for their training are often in English, whereas university materials are in Russian, so the universities have a translation problem to deal with that the big firms do not have to face. When this point was raised in the course of the interviews with university professors, they replied that this inherent weakness could be overcome by the professors, who would correct any mistakes in the course materials. But while this may be true in some cases, it probably is not true in all cases, especially in those cases where the professor is not able to read IAS in the original English. In such cases, the professors will have to rely on the Russian translation, and they are likely to repeat the mistakes that are contained in the translated materials.

It will take a long time to fully implement IAS in Russia. The process is ongoing. However, it will happen, at least to some extent. If government continues to dominate the rulemaking process, RAS will never be identical to IAS, for the several reasons mentioned above. But if the market takes over, Russian enterprises that want to attract foreign capital will prepare their financial statement using IAS anyway. Government involvement in the standard setting process will merely serve to complicate accounting and make it more expensive.

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Mechanism of Mandatory Fiscal Audit and the Ownership Concentration in Mexico

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Abstract

Our research extends existing models of asymmetric information in the auditing process in two ways. First, we include government as a third player making audited financial statements for fiscal purposes a legal requirement. We also consider different levels of concentration of ownership. We argue that both factors may induce managers to issue fraudulent sets of information, which, in turn, affects audit risk. In this study we set dominant strategies for both the firm SAT and the independent fiscal auditor under the mechanism of mandatory fiscal audit [1].

Introduction

Government is an important stakeholder in the financial results of a firm. In Mexico an important part of the government income derives from corporate taxes. The legal figure of a mandatory auditor's report that forces firms with a income over US$250,000 to have their financial statements examined by an independent fiscal auditor [2] attest to the importance of this source of income (and the firm's incentive to evade them). The auditor is authorized by Mexico's Tax Administration Service SAT (Servicio de Administración Tributaria,) and has to issue an opinion as to the veracity of the financial statements and the fiscal situation of the firm. This mechanism presents obvious costs to the firm.
This document is made up of three sections, section I comments related Literature, section II describes the model, and section III concludes with a discussion on the results.

Section I

Much has been written on the Principal-Agent problem between the managers of the firm and its stockholders. Managers possess generally superior information about a firm's operations. However, because their incentives are not always perfectly aligned with those of the other stakeholders in the firm (i.e. stockholders and government) management may not be willing to reveal all of their relevant information voluntarily and truthfully.

In Mexico, this situation is altered in one important way: Many firms are family-owned or controlled. This concentration of decision-making power makes the principal-agent problem less acute but if anything, enhances the incentives to minimize tax payments. However, as ownership becomes more dispersed and family control weakens, the interests of both government and outside investors become more aligned in their needs for truthful revelation of information.

The paper shows how the existing scheme of sanctions in Mexico is heavily skewed against the auditor, i.e. the auditor is liable award fines for mistakes and/or negligence in the auditing process and is subject to scrutiny by the state. However, there are no legal sanctions attached to a firm trying to hide or only partially reveal relevant information or otherwise misleading the auditor. Therefore the firm has a strong incentive to manipulate the information in its favor. Either the manipulation is detected which implies only paying the full and fair amount in taxes, or it goes undetected implying the firm will be certified and thus the probability of being audited directly by the tax authorities is reduced substantially. For example, as the audit is mandatory and involves a cost to the firm, the firm has an incentive to try to reduce the amount of taxes payable so as to, at the very least, cover the costs of the mandatory audit.

In the physics, the resulting vector of two or more vectors with different directions and forces shows clearly to the sum and subtraction of efforts. Those vectors are characterized to have two fundamental elements: effort and direction. Suil Pae and Seung-Wean Yoo 2001 show in their model elements like, the level of investment in systems of internal control and the auditors' legal liability, influence in the effort level that she applied to her engagement. Brayan Cloyd 1997, in his study shows evidence about the importance of accountability and the auditors' previous knowledge on specialized fiscal aspects. These elements have influence in the application of auditors' efforts on the field of information search. Paul Newman, Evelyn Patterson and Reed Smith 2001, establish that the managers have private information and beforehand they know the standard procedures that the auditors will apply when reviewing the financial information. Fiscal profit is a function of the financial profit and when revealing one the other is revealed inevitably. Kenneth J. Klassen 1997 mentions in his investigation, managers frequently encounter situations involving a trade-off between financial reporting a tax incentives reporting. On the other hand this author also show that the concentration in the ownership influences in the magnitude of the income reveled by firms in divesting operation. Frank B. Gigler and Thomas Hemmer 2001, develops theory where they demonstrate that the managers have private information and they are willing to revel unless stockholders give them the right incentive. John Evans, Lynn Hannan, Ranjani Krishnan and Donald Moser 2001, demonstrate how the managers are able to lie if they have opportunity to obtain gains when doing it. Jefrey Wilks 2002 and Hun-Tong So and Karim Jamal 2001, show how human factors can effect the audit's process focused to gather evidence fails. Joseph Carcello and Ferry Neal 2000 undertook a study where they show how the audit committees can push the auditor in order to influence in her opinion.

Inside the theory of incentives - as principal-agent - it says to us that the participants in a labor relation or under specific contract will direct their efforts in direction of their own interest. However, when this theory is not new, its application in audit mechanisms has not been full applied. In our model we show that the audit efforts must be greater under a scheme of mandatory fiscal audit.

In a mechanism of audit with the correct aligned incentives, the interested one in validating the information of a firm, it is the one who must contract the services of the auditor. Under a scheme of voluntary audit [2] if the stockholder wishes to test the veracity of the information, he must contracts the auditor. In case that the stockholder loses interest in verify the information, it is not reasonable to hire an auditor and pay her fees. This becomes true when stockholder can observe all completely the fiscal and financial information, and as a consequence there is no asymmetric information.

For practical effects the taxable income is derived from the financial income, therefore fiscal income is a function of financial income. When the managers reveal the financial income it reveals inevitably the taxable income to SAT.

In 1991 under the presidential mandate of Carlos Salinas de Gortari, he gives origin to an initiative of reform to the Fiscal Code of the Federation (CFF) this Code regulates the legal framework of other fiscal laws. This reform changed dramatically the audit market. This initiative approved by the congress has the purpose of forcing to sector of Mexican firms, with medium and high administrative capacity to be audited by fiscal purposes by Authorized Public Accountant [ ]. This reform was inserted in the article 32-A of the CFF and it is enforced until to day.

The problem of asymmetric information between the three participants in the Mexican audit mechanism - proprietors, government (SAT) and auditor - with respect to the manager, places to SAT and the stockholder under the same perspective of the incentives, they want that the financial set issued by the manager reveals trustworthy information of the firm to calculate their participation in the gains or the firm. It is critical for the model assume that the figure of manager and stockholder and SAT are different people or institutions with interests not necessarily common.

Section II

The ownership concentration could be measured in continuous form by a concentration index

$$s_i ? \frac{x_i}{? x_i}$$

$$h(s) ? \overset{n}{\underset{i ? 1}{?}} s_i^2$$

$$0 ? h(s) ? 1$$

i is the stockholder or block of stockholders, where it is the participation in the income of the firm and $h(s)$ is the ownership concentration index of the firm to be audited. As $h(s)$ tends to zero the ownership concentration become atomized, and on the inverse when it tends to one. Ownership will have concentrated by a single stockholder or block of stockholders.

Nevertheless in our model we used just two levels of ownership concentration, h_L for low, and h_H for a high concentration in a single stockholder or group of stockholders with same interests. Under a fiscal audit scheme, the fraction of the cash flows generated by the firm that go to the stockholders is:

$$?_S ? \tilde{x}(1 ? ?)(1 ? ?) \text{ where } \tilde{x} ? 0 \qquad (1)$$

$\tilde{x}$ is the cash flow base of distribution among the stockholders, manager, and SAT. This amount has already deduced the audit cost.

$?$ is the fiscal tax rate.

$?$ is the fraction of the cash flows that go to the manager as a part of their compensation.

The fraction of the cash flows generated by the firm that belongs to the SAT is $?_G$:

$$?_G ? \tilde{x}(?) \qquad (2)$$

The fraction of the cash flows generated by the firm that belongs to the manager is:

$$?_M ? ? \tilde{x}(1 ? ?) \qquad (3)$$

The variable part of the compensation of the manager is only the critical one, and that gives the incentives to deliver dishonest information to outsiders in some cases. Given equation 1, 2 and 3 we can infer:

$$?_M ? ?_S ? ?_G ? \tilde{x}$$

$$?_M ? f(\tilde{x}) ? f'(\tilde{x}) ? 0$$

$$x(1 ? ?) ? ?_M ? ?_S$$

$$?_M ? ? [\tilde{x}(1 ? ?)] ? ?_S ? 1 ? ? [\tilde{x}(1 ? ?)]$$

When the firm type is h_L the figure of manager and stockholder is clearly separated. This implies a high degree of asymmetric information between stockholders and managers. As a result of this asymmetry of information, and in combination with the equation (3), the manager always will have incentives to lie revealing greater x than the really one the firm generates. This way the manager gets a greater participation from the real x. On the other hand, the auditor is not sanctioned by the SAT because the firm will have paid taxes in excess at the end of the period. Expressing the gross gains without sanctions, we have the following equation.

$$g_M ? ? ?(1 ? ?)(x_F ? x_T)? \text{ donde } ?x_F ? x_T ? ? 0 \quad (4)$$

x_F is the income reported by the manager under a set of fraudulent information.

x_T is the correct amount under a set of reasonably well operated information.

g_M is the additional gross gain obtained by the manager to lie and to reveal the greater x that real one.

In the state of type h_L the manager's incentive goes against the stockholder interest, since a great and false x transfer a greater part of the cash flows to the SAT and the manager harming stockholder's cash flow participation, then the stockholder cooperates with the independent fiscal auditor to validate x. the auditor when to reveal the real x assures for the SAT participation of the cash flow according to the law, and the stockholder receives the right part of real x.

On the other hand, when concentration of ownership is h_H, stockholders and Manager are practically a same person or institution. The only gain that persists is the stockholder gain. Then stockholder tries to extract the greater cash flow it is possible.

$$g_S ? g_M$$

$$g_S ? (1 ? ?)?? ?x_T ? x_F ?? \text{ donde } x_T ? x_F \quad (5)$$

Where:

g_S is the additional gross gain obtained by the stockholder-manager to lie and to reveal an x minor to the real one.

In the rest of this paper we will refer just as a manager. This because the stockholder practically becomes manager in firms type h_H, and we will make the distinction only when the managers of the different types of firms will be comparing themselves. Also we will talk about a single g like the fraudulent gross gain:

$$g ? g_S$$

Under the scheme of mandatory fiscal audit, the fiscal report emitted by the independent fiscal auditor includes in all the cases the computation of $x?$, in order to inform to SAT about the tax that was given voluntarily to the SAT by the manager. The independent fiscal auditor in all the cases is contracted by the stockholders, and they select the auditor with the experience and reputation that considers advisable to its interests. As long as the auditor fulfills the SAT's entire requirement to be an authorized fiscal auditor.

When the firm is type h_H, $?$ it tends to a value near zero, and the incentives to lie about x are reversed in cooperation with a firm type h_L. These incentives are showed in the equation (1). As consequence manager could issue a fraudulent set of information that it contains smaller x than the real one. Additionally the manager plays this game with the probability distribution of deceiving the auditor by means of the issue of a set of fraudulent information, and that this set of fraudulent information will be certified. Additionally the manager measures the probability of being detected by the process of revision of the SAT.

For practical effects, we analyze the firm when is critical for the auditor and SAT. That is when the firm is type h_L, because it is the unique type of firm that its managers have incentives against the interests of the SAT, and might intent to make gains diminishing the payment of taxes. This case could lead in sanctions for the auditor and firm in case that the job of the auditor issue a wrong report that harm SAT interest and that report will be reviewed by SAT and it detects the illicit gain of the manager.

Considering the possible sanctions that the law could impose to the managers we have:

That if $g ? S_M$ the incentives are conserved by the manager to lie and to issue a set of fraudulent information.

Where S_M is the present value of the sanction.

We have then the following model:

Assumptions of the model

The model operates in a market where firms are under a mandatory mechanism of Fiscal Audit. The firms that are not under this mechanism do not audit they set of information voluntarily for fiscal effects.

Fiscal income is a function of the financial income and when it is revealing one the other is revealed inevitably, due to an easy procedure of conciliation between both.

The audit costs are constant and it is a fix costs for the firm. These costs do not have in practical form an alternative application since the law forces the firms to cover them.

The costs *C* that the SAT incurs in its revisions are relevant because destining the cost of a revision must have the benefit to recover omitted tax and sanctions. Something else generates a loss to SAT. The departments of revisions of the SAT work under cost-benefit scheme. Applying its resources of revision under the criterion to review companies with high probability that it issued a set of fraudulent information and as a consequence it omitted payments of taxes.

Sanctions are those that apply the Mexican government through the SAT, when it find underpayments of taxes. Those sanctions are directed to auditor and the manager in specific cases. It is not part of the model the sanctions among individuals due to unfulfilled contracts.

The manager mainly perceives his compensation from a fraction the value of financial income made. The fix compensation is so small that it does not change nor it influences in the incentives created by the variable compensation.

The audit market this made up of a large supply of fiscal audit services, so that the firm has the negotiation power to contract an independent fiscal auditor without restrictions. This does not imply to have damage by an increase in the fees of the fiscal auditor.

The firm is not forced to contract the same independent fiscal auditor in consecutive periods. In other words the firm has the option to change it at the end of each audit.

It only exist two levels of ownership concentration: h_H that is high and h_L that is low. These levels of concentration are perfectly observable by all the agents.

The process of audit under the mandatory regime occurs in three steps. First the set of information by the manager is issued. Second an independent fiscal auditor audit the set of information and issue a report to stockholders and SAT. Third the SAT selects a sample of all the received reports to find taxes omitted by the manager and not detected by the auditor. It award sanctions to the auditor and the manager. These fines are independent of the collection of the omitted taxes. The scheme of sanctions is showed in the following figure:

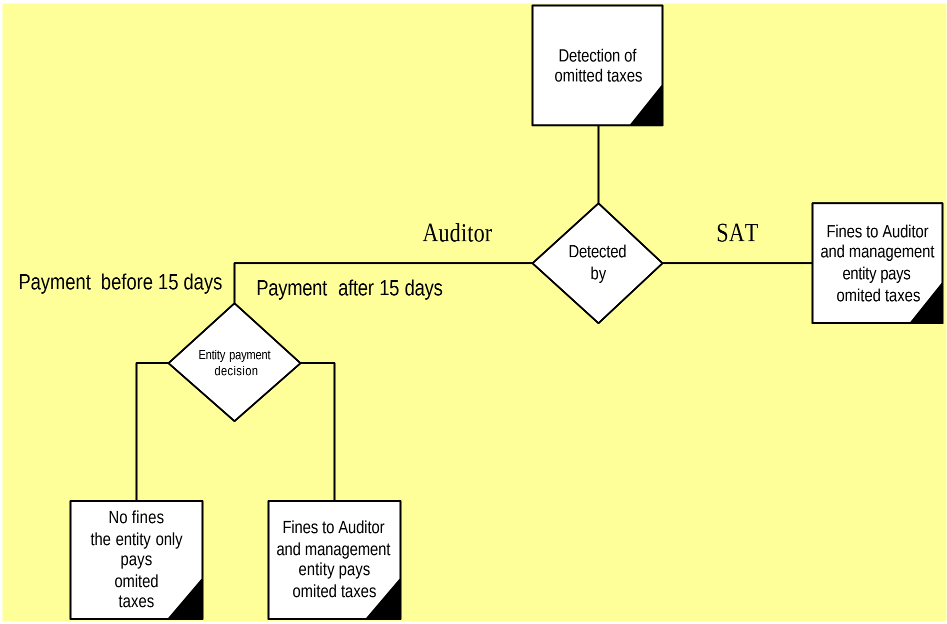

Fig. 1

If we considered a Game where a subject firm to mandatory audit can be type h_L or h_H it is forced by the law contracts an independent auditor to issues a report that includes the payment of the taxes $x?$. The auditee issues a True set of financial information I_T or one false one I_F and reveals it to the auditor for its examination. The auditor examines the information applies his standard procedures and issue a report with his opinion on the taxes paid by the firm. This he can be unqualified R_U or adverse R_A. In case of a R_U report the SAT observes the report of the auditor and decides to review it or no. A report R_A contains the tax omitted by the auditee represented by g . In this case the 15 day rule is applied [3]. In case that the auditor issues a R_U report, the SAT can review it with a probability $?$ and a probability of $1? ?$ of not reviewing it. In case the auditor issues a R_U that comes from an I_T, it is not critical the revision of the SAT since neither auditor nor for the auditee award sanction. S_A It comes only when R_U it comes from I_F and is reviewed by the SAT.

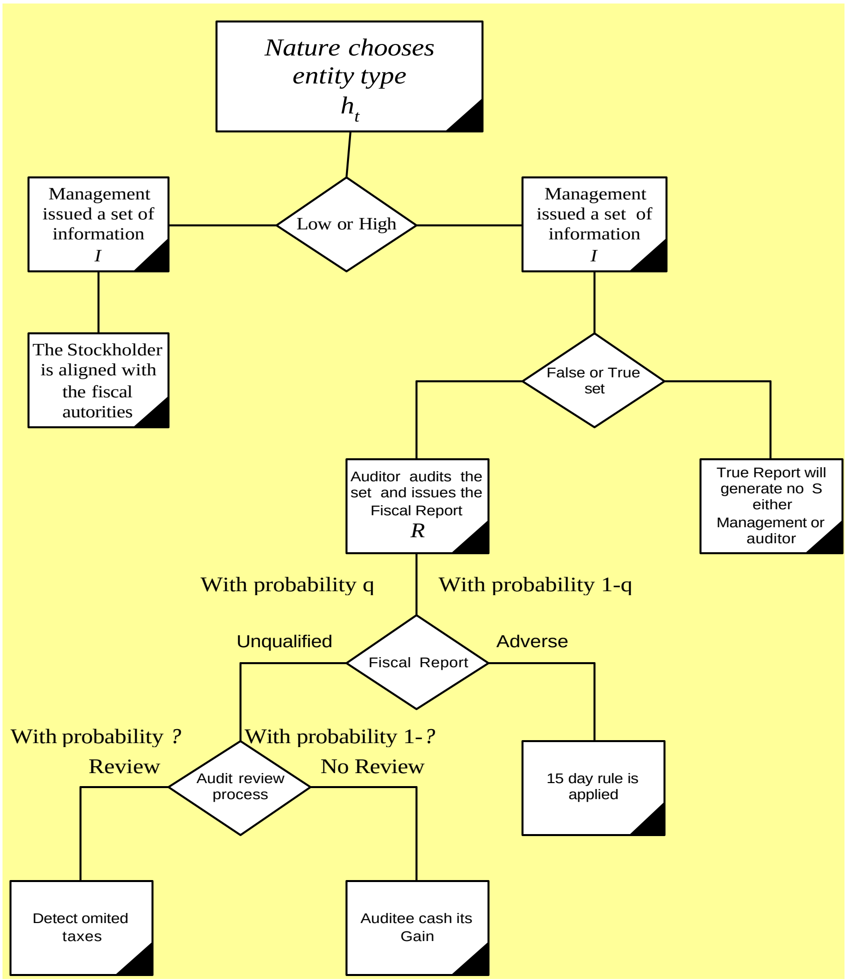

Fig 2

Set the process of the mandatory mechanism of audit; we can analyze the different strategies from each one of the participants. For the firm the set of strategies are formed by the types of reports that can issue: $Strartegy_{Entity} ? \{I_T, I_F\}$. While the SAT its strategies available once the independent fiscal auditor issues his report is to review or not to review the report of the auditor: $Strartegy_{SAT} ? \{\mathrm{Re}\,view, No\ \mathrm{Re}\,view\}$. Figure 3 shows payoffs for each one of them.

PAYOFF TABLE

Entity

SAT	I_F	I_T
Review	S-C,-S	-C,0
No review	-S-g+C, g	0,0

Fig 3

It is Prudent to mention that g cannot be a loss for the firm or a gain for the SAT because g is an amount that beforehand had to be paid by the firm and to be received by the SAT.
Payoff is represented in pure strategy, nevertheless can be added to the assumption that the SAT knows the probabilistic distribution with which the firm could issue a set of fraudulent information. This would turn the th game as mixed strategies.
Since the economic benefit of the program of revision of the SAT this set by:

$$g ? S ? C$$

Figure 4 shows a table of payoffs from the perspective of the independent fiscal auditor and the firm. Where clearly show how the dominant strategy of the auditor is to detect. The previous happen because no of the remaining strategies in combination with those of the firm, grants the security to him of not being sanctioned.

PAYOFF TABLE

Entity

AUDITOR	I_F	I_T
Detect	0,0	0,0
No Detect	$?S_A, \; g ? (g ? S_M)$	0,0

Fig 4

In case they are combined a fraudulent report and that the auditor does not detect, this subject to be sanctioned with an firm and the independent fiscal auditor expected value $? S_A$ to obtain a gain with probability $(1 ? ?)$ and a sanction with probability $?$. If the firm can observe the penalty that him can be imposed, and knows the probability of being detected by the SAT. Its dominant strategy will be to lie if:

$$g \; ? \; ?(g \; ? \; S_A)$$

The auditor has a greater audit risk, if we considered that their procedures of audit are always fairly the same for any entity type and these are not designed to be applied in different basis on fraudulent reports.

Section III

Discussion

While the Mexican SAT agency does not increase the sanctions for the firm by the simple fact to issue a fraudulent report and that it is detected by the auditor, creates incentives sufficient to try to deceive the auditor and to obtain fraudulent gains by means of fiscal evasion. Sufficient elements in the audit market exist to infer other inefficiencies in the scheme of mandatory fiscal audit associated with the price of the audit received by the auditor and the contingent debt that acquires when audit firms with incentives to lie. But the heterogeneity in the quality of the services of audit even allows the firms to select auditors who increase the probability of issuing an unqualified report when he had to be to adverse.

The strategy of the SAT to obtain the greater collection of omitted taxes with the limited resources that it has, will be to oriented a greater number of revisions to reports of independent fiscal auditors from firms of high ownership concentration. This will be able to probably offer the best combination between cost-benefit due to revisions.

The SAT will have to analyze the variables around the fiscal audit mechanism to make it socially just and efficient.

References

Contact the Author for a list of References.

End Notes

Contact the Author for a list of End Notes.

Section 8
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Global IT Outsourcing: Where Does Mexico Stand?

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Abstract

This paper discusses the current state of IT outsourcing at the global scale. It analyzes the current controversies/debates on whether the global outsourcing meets the stated cost savings objectives. The paper argues that the global IT outsourcing is going to be a dominant phenomenon for the next 5 to 10 years and that there would be plenty of opportunities for countries like Mexico in the area. The paper provides a brief summary of the state of the Mexican IT industry with the objective of identifying the opportunities for the Mexican IT companies in the outsourcing area. Then, the paper presents a selection framework that an outsourcing company can use to prepare itself to enter in this market. Finally, the paper discusses the steps Mexico can take to provide its IT industry a better IT infrastructure so as to improve their prospects to succeed in this global endeavor.

Introduction

Global Outsourcing (also known as offshore sourcing) has become a common phenomenon in the IT world. India, propelled by its skilled IT labor force and lower wages, is undoubtedly the leader in providing outsourced services. Other countries - China, Philippines, Ireland , Mexico, Romania, Australia, South Africa, to name a few - are trying to build an IT services sector to exploit the outsourcing market. The client companies (customers), mainly located in high wages Western countries (mainly, USA and Western European Countries), are looking for, in addition to reducing the costs, diversification in order to reduce any political or business risk resulting from depending on one company or one region. Also, Companies are experiencing the shortcomings of the "follow the sun" strategy in selecting an outsourcing company. The day and night time difference is causing stress on the domestic employees. There is already a talk of "near-sourcing", i.e, using a company located in the neighborhood of the client company. There lies the opportunity for Mexico to capture the business outsourced by US companies. Mexico provides sttong talent at lower cost close to the United States [1]. In fact, the leading Indian IT companies, in anticipation of this trend, have already opened their offices in Mexico and Canada.

The work presented in this paper is part of the ongoing research on the global (offshore) outsourcing that the author is pursuing. This paper focuses on the current position of Mexico in the IT outsourcing, what Mexico has to offer, what it lacks and what it can do to be ready to exploit the next phase of outsourcing - BPO (Business Process Outsourcing). The remainder of the paper is organized as follows: Section 2 discusses the current IT outsourcing market and its future direction; Section 3 presents the current debate on whether offshore outsourcing delivers the promised cost savings; Section 4 analyzes the state of the Mexican IT industry and its current position in offshore outsourcing; Section 5 presents a framework that an IT company can use to prepare itself for entering the outsourcing market; finally, Section 6 presents a summary of the main points of the paper.

IT Outsourcing Market

With the power of telecommunications, it is now possible to access skills for almost everything - from answering the telephone to developing computer systems - at a fraction (10% - 20%) of the costs in the USA. The U.S. market for outsourcing is expected to grow at an average of 13.6% annually between 2001 and 2005. Forrester Research, the IT analysts, predicts that offshore outsourcing to India from the US will grow by 25 % in 2003. In November 2002, Forrester estimated that the number of US IT jobs going offshore would rise from 27,000 in 2000 to a cumulative total of 472,000 by 2015. In the Western Europe the market for offshore outsourcing will grow by 40 per cent this year, according to Gartner, while Ovum Holway, the leading industry analyst company specializing in the performance of the UK software and IT Service (S/ITS) industry, forecasts that by 2006 between 20,000 and 25,000 UK jobs will be lost as IT work is moved offshore. The Indian software and services industry, whose export revenues were worth about $9.5bn in 2002-03, accounts for 90 % of global offshore IT business. According to a survey by Deloitte Consulting, the world's top 100 financial institutions will make annual cost savings of $138bn in the next five years by moving operations to offshore locations, resulting in the loss of 2 million jobs in financial services in western countries. All the above data has been extracted from a special report in Financial Times [2].

While one can debate the accuracy of these estimates, it is clear that there will be a tremendous opportunity over the next 5 to 10 years for low wages, high skilled countries. Undoubtedly, Mexico should be a player along with the countries such as India and China. Even though the loss of jobs is provoking resistance [3] to the offshore outsourcing in the client companies, there is strong evidence that the offshore outsourcing are making many industries competitive and thus saving overall more jobs (mostly, non-IT jobs) than are lost by outsourcing. .

In response to the outsourcing threat, the leading incumbents (IBM, EDS, CSC, Accenture, etc) in the IT outsourcing market are scrambling to keep up by setting up facilities in India and other offshore locations. This has made the Indian IT market tight - skills are in demand, salaries and overheads have gone up. Smaller incumbent IT companies are seeking alternate locations. Governments of China. Philippines, Brazil, Mexico, Malaysia, the former Soviet states and countries in Eastern Europe are promoting the development of the infrastructure and skills to deliver offshore IT services. According to Forrester's Stephanie Moore. China is not yet a suitable location for North American and European companies. "The market is too immature and problems associated with this immaturity - the lack of English language skills, the legal and regulatory environment, the lack of intellectual property laws - make China too risky today." Once again, this is an opportunity for Mexico.

In terms of longer term prospects, the offshore outsourcing in the USA is expected to continue. The USA will experience a labor shortage of 5.6 million by 2010 due to the graying of American work force [4], and hence the USA will need outsourcing to make up for the shortage.

The Future of Outsourcing - BPO

According to a survey of the InformationWeek 500 companies conducted by Information Week magazine and reported in its October 20, 2003 issue, "2 in 5 companies report they are outsourcing business functions, including 43% of health-care and medical, 42% of banking and financial services, 32% of manufacturing and 29% of IT sites that participated in the study."

Prudential, GE and Citigroup are among scores of companies outsourcing to India not just "safe" back-office jobs, but increasingly high margin tasks such as actuarial analysis. The consequence is that India's IT-enabled services (ITES) sector is set to continue its recent annual growth rate of 60 per cent plus this year, and emerge as a powerful source of job creation. Nasscom, the Indian industry group, says 1 million ITES jobs will be created by 2008 in India [5].

The driving force is the increasingly tough business environment in the west. The pressure to remove costs is forcing companies not only to consider Indian companies for IT jobs that might typically have gone to an IT global major; clients are also embracing outsourcing in general and India in particular. The appeal is initially costs; India's graduate level staff cost a fraction of their western counterparts. But this wage factor is increasingly overshadowed by the productivity and efficiency gains. Typical is introducing systems that reduce the number of errors on, say, a credit card application. This reduces the time spent on a potential client and the cost of capturing potential new business. In summary, the cost savings, increased productivity and efficiency gains are driving the movement toward the outsourcing of business processes in the services (financial and others) sectors [6].

The Global Automotive Practice of management consultancy firm AT Kearney found in a survey of 40 Automobile executives in North America that 90% of them intended to move non-manufacturing processes to low-cost offshore locations. The most popular destinations for the migration of business processing activities found were India (with 24 per cent executives voting in its favor), China (15 per cent), Mexico (13 per cent), Brazil (10 per cent) and Czech Republic (8 per cent) [7]. "India is clearly the destination of choice for business processing services across all industries. There are tens of thousands of well-educated, English-speaking and highly motivated engineering, IT, and accounting professionals in India with the skills and capabilities auto manufacturers and suppliers need for offshore business processing," Mr Nagi Palle, co-author of the research and a principal at AT Kearney said.

While India certainly has a lead, there would be a plenty of opportunities for Mexico, provided it can offer the same level of IT infrastructure and skills set.

IT Offshore Outsourcing Controversies

Are the savings for real?

In a recent much published report, "Hidden Cost of IT Outsourcing" [8], it is reported that many companies come short in realizing the promised cost savings. Indeed, offshore IT outsourcing can be a lot more complicated than moving traditional manufacturing operations overseas. IT quality (or the lack of) is much more difficult to gauge. IT being an integral part of every business process requires a greater degree of knowledge transfer and management. On paper, it looks extremely attractive. A Russian programmer charges 80% less than an American. But when you parse it all out, the total cost of offshoring a given IT job is generally comparable to getting the work done domestically, says Tom Weakland, a partner at management consultancy Diamond Cluster. It's just that few companies are aware of these real costs. "Most companies can't accurately measure their productivity and costs prior to and after outsourcing," says Weakland. " "Most look just at wages."

It is claimed that programs developed offshore have a lot more software bugs than software programmed domestically -- usually 35% to 40% more. Costs add up even when offshoring is done right. Many companies tend to send expatriates to set up their operations abroad -- and their wages usually run high. There are cost of additional executive travel and the cost of extensive training in language and culture. Also, there is the cost and inconvenience of managing offshore crews resulting from different time zones.

To tap into this disillusionment, some small U.S. companies, such as RTTS, a privately held test-automation consultant, are offering competitive rates to lure back business from offshore companies. "It's the same model as India, but there are no time-zone and language issues to deal with," explains Bill Hayduk, director of professional services for RTTS. "Customers going offshore aren't happy with the quality they're getting. So we think there's a big opportunity for us." Herein lies another opportunity for Mexican IT companies to partner with companies like RTTS and share the pie.

Counter View: Outsourcing's Benefits Too Much To Ignore!:

According to AMR Research, the number of IT companies that outsource will jump from 20% to 50% in three years. "Cost savings from outsourcing are too compelling to ignore [9]…" Network advances in security, leased lines, VPN technology and storage all contribute to making offshore outsourcing painless for the experienced IT manager who may have a tight budget "Almost everyone who does a first offshore [job], has a problem," Travis says. "The second and third attempts gradually get better." The culprit is often a bad process that existed at home and subsequently outsourced.

Mexico’s IT Industry & Its Current Position in Outsourcing.

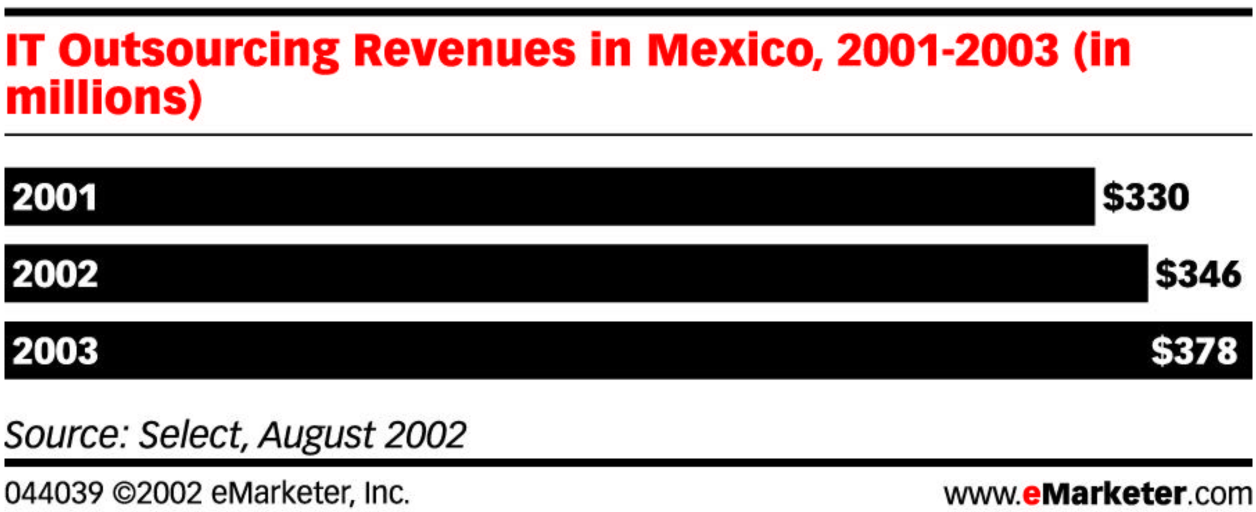
Mexico's IT Industry: According to a report by Unteagra-Trani [10], there are approximately 500 software development companies in Mexico. Foreign software developers supply more than 80 percent of packaged software to the Mexican market. However, excellent opportunities exist for customized software in Mexico, as imports account for only 10 percent of the market. Softek, Hildebrand and EDS are the largest developers of customized software in Mexico.

The report states that in 2002, "enrollment in IT programs accounted for 10 percent of total enrollment in Mexican universities. During the past three years, IT enrollment in universities has grown more than 10 percent annually. Approximately 153,000 students enrolled in university IT programs in 2000, a 14.5 percent increase from enrollment in 1998. In addition, nearly 309,000 students registered in community college IT programs the same year."

Mexico encourages cooperation between university IT programs and the private sector. The Center for Design Innovation (CDI), a software development company, and the Instituto Tecnológicoy de Estudios Superiores de Monterrey (ITESM), have an alliance to provide to students and teachers practical training. The Progress

University Program in Mexico offers software and training to universities at no cost, in return for university use and promotion of Progress-based courses. As of 2001, more than 8,000 students have graduated from the Progress program in Mexico.

Outsourcing in Mexico: Mexican outsourcing companies have so far, by and large, failed in convincing US companies to outsource operations in Mexico. Mexico's IT outsourcing revenues are presented in the figure below. More than the numbers being low, the more disturbing trend - there is not much growth over the least three years. A recent story in New York Daily News dated January 20, 2003 reported that "companies like GE, Oracle, British Airways, …Ford, Citigroup and Microsoft are outsourcing thousands of jobs to India, attracted by an educated workforce of 250 million English speakers and lower costs." The article went on to cite a Forrester Research report that said " Over the next 15 years, 3.3 million services industry jobs and $136 billion in wages will move offshore to countries like India, Russia, China and the Philippines." The notable omission is Mexico.



The CIO Magazine, however, recently (August 2003) rated Mexico as an "up and comer" in outsourced IT services. It stated that the success of companies such as SoftTek and Hildebrando was a good sign for the future. The North American Free Trade Agreement (Nafta) ought to make it easier for American companies to do business in Mexico than in other developing countries that may offer similar cost savings. With growing US concern about political stability and terrorism threats else where, it appears that Mexico offers a way to outsource "near shore", rather than offshore. SoftTek, based in Monterey, Mexico, for example, offers what it calls a "near-shore delivery services model" that it claims can combine "the quality, responsiveness and flexibility normally associated with domestic outsourcers with the cost-savings of an offshore development facility".

Meanwhile, Mexico is gaining near-term outsourcing success in call center operations designed to meet the growing needs of US Hispanic consumers. The London-based Datamonitor research organization, states in a report (April 2003) Opportunities in Caribbean and Latin American Call Centre Markets to 2007: "Mexico will claim the fastest growing market for outsourced 'agent positions' through 2007, driven in large part by the efforts of outsourcers attempting to service the Spanish-speaking population in the US." It appears Hispanic Teleservices is winning business for its Mexican operations. Only last September, the company announced the addition of a second contact centre, in Monterrey, that has a capacity of 540 call centre operators and is designed to operate around the clock.

Near shoring: an opportunity for Mexico

Indian IT firms are finding nearshore centers a useful vehicle to develop new business. Uruguay, Canada, Mexico are fast becoming hot destinations for Indian software firms to set up centers as these locations provide easy access to the US. TCS, another Indian IT company, has centers in Uruguay, Hungary, China and Australia and is planning to open a center in Chile. The nearshore approach gives Indian firms the ability to front-end customer engagements that require presence in the same time zones while doing other development/ maintenance work to India.

In near shore operations, Mexico faces competition from Canada [11]. Both Canada or Mexico can offer significant economic advantages with lower risks and greater geographic and cultural accessibility. Canada, given the language and cultural affinity to US, is very attractive to many US firms for outsourcing applications work offshore. Moreover, the two legal systems work well together, making it easier to protect intellectual property. Mexico, however, has the cost advantage. Since many nearshore operations involve local hiring (some Indian companies use 80:20 rule in favor of local hires), there is an opportunity for Mexico to create new jobs.

In the longer term, Mexico's IT industry has another revenue source - the internal IT outsourcing. So far, only 10% of the Mexican companies have outsourced their IT operations.

The next section discusses a framework that has been used by client companies in preparing for outsourcing and in selecting an offshore outsourcing partner. The understanding of this framework is essential for the **Mexican** IT companies to prepare themselves for entering this market

Outsourcing Company/ Region Selection Framework

The selection framework used in this paper consists of examining (1) the driving forces for outsourcing – tactical vs. strategic, (2) the process used to decide what to outsource, (3) selection of the operational model – inter-workings of the in-house staff and outsourced-staff, (4) the process to select offshore vendors and region , (5) the quality of contract negotiations – thoroughness, risk analysis and contingency planning, (6) quality of execution and program management – team formation, transition, knowledge transfer, work and relationship management, (7) and the quality of results – SLA's conformance, customer satisfaction.

The components of the above framework have been discussed in the literature on outsourcing. Most of the material is available in the leading trade (IT) magazines (Information Week, MIS, etc.), financial sections of leading newspapers (Financial Times, WSJ, NYT, etc.) and IT journals (Optimize for example). A selected bibliography [12 through 17] is provided at the end of this paper. Most of the material has been around in the context of developing business strategies (core competencies), contract negotiations, risk management, program management, and cultural aspects of doing business in a foreign country. It is being reapplied to outsourcing. The practical challenge here is in how well these ideas are applied to a given outsourcing situation and then executed to achieve the results.

Driving Forces

There are two types of driving forces that motivate a company to outsource – strategic and operational. Strategic goals include being able to react to market conditions quickly, being able to bring a product in a shorter interval, ability to compete for new business. Operational goals include reduction of costs, increased margins and control of products while ensuring the quality of work. Even though it is a cliche to be strategic, often companies who are fighting for survival must focus, in a short term, on operational goals such as lower costs.

Process of deciding what to Outsource

Fundamentally, a company ought to outsource what it cannot do well or can get it done cheaper or what will bring other profitable business in-house. The first has to do with the lack of core-competency; the second has to do with the inefficiency of in-house operations; and, the third is a by-product of partnering with the outsourcing vendor. First of all, let's understand what not to outsource. One should almost never outsource processes or functions that involve interactions with customers. If you give the impression that customer issues are not important enough to warrant your attention, customer will sooner or later find someone who does. This is contrary to current practices of outsourcing call centers or product support functions. If one must (for cost savings), companies ought to have an overseas captive center that is an extension of the company as opposed to giving it to an outsourced center.

One ought to examine all the functions of a system development life cycle (SDLC) from two angles - the potential relative (to in-house) value created if outsourced and the relative higher risk that outsourcing brings to the table. The functions that yield most value and present least risk are the candidates for outsourcing. Typically, in the software industry, software coding and testing functions fall in this category.

Selection of the Operational Model

This is one of the most neglected parts of planning for outsourcing, often relegated to the time when for all practical purposes decision to outsource to a particular company has been made. Current practices can be grouped into three models – autonomous operations, partial autonomous and staff extension model. In the first model, the vendor is doing all or majority of the phases of a project and there is very little interference from the customer company (that outsourced the project). The pros of this model include reduced need for local (in-house) staff and shifting of the risk for project overruns to the vendors. The cons are loss of control and loss of know-how. In general, this model is suitable for non-strategic, final stages of the life cycle projects. In the second model, some project phases are outsourced while others are being done in-house. This model requires a great deal of cooperation between the two staff as well a high quality of knowledge transfer. Proper documentation and training are a must for the success of this model. The pros and cons of this model are similar to the first model on a varying scale. This model is suitable for well defined projects whose components have well defined interfaces. In the last model, vendor staff works as an extension of the in-house staff. This poses its own challenges in terms of accountability and manageability of work. The pros of this model is that it keeps the knowledge base at home, it is easier to adapt to rapidly changing requirements and it is less threatening to the local staff. This model is more suitable for strategic projects.

Process to Select Outsourcing Vendor and Region

Simply stated, the vendor must have a track record of core competency in the functions you want to outsource. It must have a stable skilled work force. It must be economically viable – its survival cannot depend on just one or two projects. It must understand the business and customer issues (even though it may not be directly involved with your customer). It must understand the client company's **language and culture**. Its employees must demonstrate the sensitivity to local staff's feelings (which can be often hostile as some of them might be losing their jobs). The vendor must be located in a **region** that is **politically stable**, has an ample **supply of highly trained workers** and the **telecommunications infrastructure** needed. It is a good practice to issue an RFI (Request for Information) that seeks this kind of information about a potential vendor. Caution here is not just to go for the lowest cost vendor, but to look at the total picture with a special eye for identifying the risk (of not getting things done, of company going into bankruptcy, of company 's failure to retain skilled staff).

Mexico as a region meets many of these requirements, even though there are some questions about the proficiency of English and rigor of its computer science/engineering programs. The physical proximity with the USA and same time zones are big pluses. There might be some cultural issues. When the author of this paper visited Mexico City for business a few years ago, he was surprised at the reluctance of Mexican counterparts in speaking English.

Quality of Contract Negotiation

Literature is abundant on this topic. In addition to a well defined statement of work (SOW) that should include the normal governance (management) process, one must put contingency (handling of the unexpected) clauses and risk mitigation clauses. The contingency clauses ought to include an immediate upper management (from both companies) review, right to obtain outside expert assistance and step-in rights that include potential termination of outsourced work and taking over by the in-house staff. It is a good idea to talk about termination rights in the beginning while both parties are in a spirit of cooperation. If work needs to be terminated before completion, the client company must ensure that the works gets completed without putting the company in a financial jeopardy. Under risk mitigation, the contract must address no-compete clause, intellectual property protection, data integrity, security and employee turnover.

Quality of Execution and Program Management

All wonderful planning and contract negotiations go to waste if they are not executed properly by both parties. Key requirements for successful execution are putting a top notch management team on both sides (program/project managers, technical managers and technical leads), selecting people with the right skills, transition activities that kick-off the outsourced work, insuring that knowledge transfer is taking place, and finally, making sure that tasks are happening or finding out quickly when they are not (happening). A common mistake companies make that team members are selected based on their organizations rather than their skills. The overall program manager has to be from the client company. He or she must have visibility in the outsourcing company so that the right people are selected in the teams. Also, the team members must be trained in cultural sensitivities – with a focus on improving their communication effectiveness.

Quality of Results

The challenge here is how to be able to see quality (or the lack of it) from a distance. As part of quality planning (quality by design), the program manager must insure that the outsourced company follows quality processes such as those based on ISO9001 or CMM5. Do not just depend on the fact that the company has these certifications. Ask for a quick audit. Also, define service level agreements (SLAs) for each stage of the project (initiation, interim and final). Define defect density, response time, defect fix time thresholds. Monitor the intermediate milestones and above all have periodic operational reviews.

Concluding Remarks

It is very clear that Mexico has a very small piece of the total offshore IT outsourcing pie, even though the Mexican government has taken steps to build the infrastructure (IT training incentives, telecom facilities, economic incentives, etc). This paper postulates certain drivers that could prepare Mexico to be the country of choice for IT "nearshore" outsourcing for the US market, undoubtedly the largest market. Mexico's real competitors in this are Canada and some neighboring South American countries. Two negatives, whether real or perceived, that need to be abolished are the lack of English proficiency and the less rigorous computer science/ engineering programs. The third element, even though sensitive to talk about and hard to change, is the cultural stereotyping that exists in the USA about Mexico. Further work is needed to demonstrate if and which of these factors are indeed enablers or inhibitors.

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Firm Competitiveness and the Challenges of Globalization: Selected Case Studies from the IT Industry in Malaysia

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Abstract

The Globalization process has increased competitive pressures on firms. In today's open and liberalized world, firms rather than nations have become the main players, bringing economic progress and development to the people. As such, their 'competitiveness' is of prime concern to all stakeholders, including the government and the people of a nation.

The process of globalization is expected to continue with technological progress and economic development. The ICT costs, one of the prime movers of globalization, will further go down and the financial liberalization will increase. Trade in services will also increase with further liberalization of the world economy. All of this will bring new opportunities for trade and investment, value creation, and market development. At the same time, globalization will increase competition and pose a challenge for firms to survive and prosper in the new (and fast changing) technological and business environment. This challenge seems to be the greatest for ICT-based industries, where the process of globalization is more smooth and rapid.

The purpose of this paper is to identify some of the major factors, which contribute to the 'firm competitiveness' and propose strategies, which may enhance firm competitiveness in developing countries. Case studies for the Malaysian IT industry are used to provide a specific context for a well-globalized economy from the developing world.

Introduction

Globalization, coupled with technological change, has altered the environment in which firms operate. In the open and liberalized global economy, firm 'competitiveness' has become a major challenge. This challenge is quite serious to developing countries, which are still in their early stages of development and lack a strong technological and business foundation.

The process of globalization is continuing at a fairly rapid pace due to the technological developments, which are taking place today in the world. Further, economic integration and liberalization of trade and investment are expected with economic growth and development of financial markets. The ICT-based industries show greater impact of globalization – both in terms of imports and export of IT products and services, as compared to other industries. This is attributable to the low costs involved in carrying out trade in information goods and the ever-increasing range of products and services, which are being produced by the ICT industries.

Malaysia is one of the fast integrators in the world economy. The country has adopted an open policy to foreign trade and investment and made remarkable progress in infrastructure development, economic growth, technology acquisition and development, education, and exports. Malaysia is also trying to promote Information and Communication Technologies (ICTs) as a means to bring about socio-economic change and to create business activities for the new economy. Multimedia Super Corridor (MSC) was established in 1996 to create the necessary physical and technological infrastructure to attract ICT investors and world-class operators. The MSC is located in Kuala Lumpur – which provides modern urban living conditions and is a hub for commercial and industrial activities in the country.

Although the programmers to promote ICTs in Malaysia are relatively young, the achievements made so far are quite impressive. By mid-May 2003, about 900 companies were granted the MSC status, which entitles them to a wide range of incentives and facilities for investment and business operations (see *Appendix* on the MSC). Out of the total of 900, about 742 companies were operational. The MDC Impact Survey [11] recorded a workforce of 21,270, 86% of this being knowledge workers. About 43% of the companies were engaged in local business only, while 57% have export business. In terms of value, however, local business was dominant, accounting for 82.5% of the total sales (estimated at US$ 1.5-1.8 billion). The key success factors for the MSC have been the heavy investments in infrastructure, excellent support services to the IT community, low cost of doing business, and modern and diverse urban environment.

The ICT-based industries in Malaysia are by and large composed of small and medium size firms. About 71% of the firms covered under the MDC Impact Survey [11] have paid-up capital of less than RM1.0 million (equivalent to about US$263,000).

As noted, local business remains the main driving force for the Malaysian ICT industries. More regional and international business is hoped for in the future. Global developments, however, indicate many disquieting factors, which may pose a challenge to the firm competitiveness in Malaysia. Some of these are the dramatic technological developments, which are taking place in the world as well as the increasing competition from the old and the new players. For Malaysia to continue with its success, regional/international businesses are important. To achieve this, a lot more has to be done to attract and retain world-class companies as well as improve the 'competitiveness' of the local companies.

The purpose of this paper is to identify some of the major factors, which contribute to the 'firm competitiveness' and propose strategies and programmes, which may enhance firm competitiveness for the Malaysian IT Industry.

Firm Competitiveness and Its determinants

Firm Competitiveness

Firm competitiveness has been defined as the 'ability to produce goods and services that meet the test of international competition, while the citizens enjoy a standard of living that is both rising and sustainable' – definition by Laura D'Andrea Tyson: quoted by Samitha Fawzy [4, p.1]. Other definitions are similar, though some emphasize 'productivity' growth of one firm relative to the others as firm competitiveness.

Definition of firm competitiveness may differ, but there is a consensus among experts that competitiveness of firms, industries, regions and nations is an important feature of the world economy. It not only affects the pattern of production, investment and trade, but also influences the relative standard of living of many countries.

Firm competitiveness somewhat differs from the competitiveness of nations – it is basically a zero sum game. Firms gain at the expense of other firms when competing. Also, when firms are not competitive, they will be out of business, though countries may still exist (probably in poverty and under economic distress).

In the competitive business world, firm competitiveness has become more complex as firms may compete in price, quality and customer services. To acquire competitive edge, the firms have to be concerned about –

- *Quality and Reliability – show a strong commitment to quality, flexibility, design, reliability, and accessibility.*
- *Technology, Organization and Market – combine technology, managerial entrepreneurship, employee skills, business organization, and software to service markets and interact with customers and suppliers.*
- *International Standards – follow/observe international standards for product safety, health and environment, corporate governance, etc*

Business Environment

Outside the firm, the national business environment substantially influences firm's ability to compete. The national business environment can have positive effects if it encourages competition among firms and provides incentives for investment, innovation, and enterprise.

Role of the Government

The role of the government is particularly important in providing the basic infrastructure and favourable business environment. Macroeconomic stability, rule of law and fair practices, transparency and accountability, pro-business and private sector orientation, simple administrative rules and procedures are some of the important requirements for creating favourable conditions for business and investment. These factors help to reduce business risks and lower the cost of doing business.

Globalization and Firm Competitiveness

Globalization is affecting firm competitiveness in many ways. It affects, through exports as well as imports. Exports compel firms to meet the competition at the international level. National markets become global as these are opened to international competitors through imports. Globalization of an industry take place when a firm produces in one country (to gain cost advantage) and sell in several countries, creating competition for all the firms in the industry.

Globalization may also affect the firm directly if the firm's value chain is decomposed and dispersed around the world to gain cost and market advantage. As a result, globalization contributes to the development of a global marketplace with intense competition. At the same time, the dispersal of the production activities helps firms to be cost-effective by benefiting from the differences in factors costs and quality. Globalization has also encouraged 'outsourcing' and broadened the options for transportation, warehousing and marketing. With careful production planning and logistics management, firm's competitiveness can be improved substantially with the 'new' economies of globalization.

The globalization of markets, industries and firms has made cost a critical element of competition. Larger firms are likely to benefit more in view of their ability to have economies of scale and scope as well as reap the 'new economies of globalization' due to their size-advantage to spend, invest, and coordinate worldwide operations. However, in their search for larger markets and opportunities, they tend to leave behind many unattended and unsatisfied market segments. These can be effectively exploited by smaller firms, which have the necessary flexibility to respond to the smaller, and more neglected market opportunities (i.e. niche markets). To exploit this potential, highly sophisticated strategic analyses of markets/industries are needed. Small and medium sized firms lack the necessary expertise and financial resources to undertake this task. However, the governments can play a useful role in filling this gap and supporting the small and medium enterprises.

Networking and Alliances

Firm's competitiveness can be substantially improved through networking and forming alliances. These can be used in research and development (R&D) for new products, create new markets, learning, and meeting customer needs. Two or more companies collaborate and complement each other, using their best competencies. Firms should develop a mechanism for improving innovation capacity through collaborative projects with network members.

Innovation Capacity

With the recent technological revolution, technology has become the most important factor determining the competitiveness of firms and industries. Firms with strong innovation capacity have a better chance to cope up with technological change and maintain (and even improve) its competitiveness. Innovation, in its broad sense, is defined any newly developed idea. It includes – both improved technology and better methods of doing things. Innovations may be manifested in new products or services, improved quality, new ways of production, packaging, marketing or distribution, new supply sources, new organization or systems [13, p. 149]. Innovation capacity refers to a continuous improvement of the overall capacity of firms to generate innovation for developing new products to meet market needs. The innovation capacity heavily depends on the continuous supply of innovation resources (i.e. skilled and technical staff, R&D activity, leadership and culture) and the accumulation of innovation knowledge. Organizational environment plays a crucial role in developing innovation capacity. Hierarchical organizational structures are found inadequate for building innovation capacity to meet the challenges of globalization, i.e. customization of product development and global linkages of product markets.

Learning

Knowledge is a strategic asset of a firm. Learning in a learning organization can be a source of competitive advantage. With networking and relational clusters, firms have better prospects of learning from one another. It improves competitiveness and is difficult to emulate by competitors [2, p.1].

Knowledge is generally dispersed – within the organization and outside. Both the external and intrafirm knowledge is needed to be integrated with a view to improving the firm competitiveness in the market. This requires a proper technology management effort, which can generate key firm competitive advantage, when guided by a market orientation [7, p.2].

Perspective on Firm Competitiveness – Selected Case Studies – IT Industry in Malaysia

The basic information on the Multimedia Super Corridor (MSC), provided in the *Appendix*, clearly shows that the ICT industry in Malaysia is dominated by small and medium size enterprises, while the bulk of the business is local.

The world-class companies (45, by September 2003) are composed of both foreign and local enterprises, though the number of foreign companies in this category is quite large. The total sales for the MSC companies are estimated at RM6-7 billion (or US$1.5-1.8 billion). If allowance is made for the imported equipment and purchased inputs by the MSC companies, the value-added may be around 30-40% (or US$0.5-0.6 billion), which is still small from international standards.

Judging by the progress made by the MSC – status companies, the trends look very impressive. The number of MSC companies and the number of k-workers doubled in three-year period (2000-mid 2003), as shown in the following-

Particulars	1997	2000	2003*
K-workers (no.)	1,946	9,842	18,922
MSC- status companies (no.)	94	429	901
Sales (RM billion)	n.a.	3.93	6.16

*Mid-May

Further success, however, will depend on the growth of IT-related business. The growth prospects of the domestic business depend on the performance of the Malaysian economy and the 'mega' projects, originating from the public and private sectors. Judging by the present economic situation, the growth prospects for the domestic business can at best be rated modest. Thus the IT-industries will have to look for business expansion in the regional and international markets. This will surely mean more competition for the Malaysian ICT industries. It will also require considerable innovation effort on the part of Malaysian companies to develop/adapt products to meet the needs of the regional and international markets.

Given the structure of the ICT-based industries (*SMEs* being dominant) and the major involvement of companies in domestic business under considerable government support/patronage, most of the local firms will face a challenge to their competitiveness.

To get a first hand assessment of the issues and problems on the ground, a study was made of 7 companies (listed in Table1) in June/July 2003. The selection of the companies was based on their reputation of being successful and dynamic enterprises. Special consideration was, however, given to the size distribution of the sample to reflect the industry structure. Four firms belong to the *SME*s category. One firm (Oracle) is a foreign subsidiary and one firm (MIMOS) is large and had considerable government support in the past.

Personal interviews were arranged with the Senior Management of the sample companies to discuss company's ownership structure, business activities and employment. The sample companies were also asked to give their views on globalization, firm competitiveness vis-à-vis other companies at home and abroad, problems faced and suggestions to strengthen the IT-based industries in Malaysia.

In addition to the seven sample companies, meetings were held with the Multimedia Development Corporation (MDC) with a view to ascertaining their perspective on the MSC companies and the future of IT-business in the short and medium term. Two Divisions of the MDC, namely Research and Development and Client Services were involved in providing the required information. Generally speaking, the response from the private and public sectors was extremely good. Although the sample is selective, it is believed that we have covered a good cross-section of firms from the Multimedia Super Corridor (MSC), which is the hub for the IT- based industries in Malaysia.

The results of study are briefly summarized as follows:

- *Financing* – small and medium IT-based companies face 'financing' problem to various degrees. Large companies are able to manage financing of their activities/projects without much difficulty.
- *Research & Development* – there is a gap in R&D. A large number of companies are not research minded and lack R&D facilities. In view of the absence/weakness of R&D, the long-run viability/sustainability of

many companies is an issue. Large and some medium size companies have R&D units and also rely on partners/principals for support.

- *K-Workers* – K-workers are in easy availability. But experienced and more specialized K-workers are in short supply. This is being tackled by hiring foreign workers.
- *Education* – IT- education and training emphasizes 'quantity'. There is a need to improve the 'quality' of education and training. English language skills are relatively weak among the local IT graduates.
- *Business Environment* – domestic market is not free and fully competitive. This retards the development of efficiency and dynamism in the industry.
- *Business Expertise* – Many local companies (particularly *SMEs*) lack business and managerial expertise. It adversely affects the development of the commercial aspects of the IT-related businesses.
- *International Business* – international business is mainly carried out by a small number of dynamic players. Institutional support for international business is rather weak.
- *Institutional Focus* – Institutional framework and government programmes are focused on infrastructure development, investment promotion, education and client services. Focus on people and innovation system is inadequate.
- *Venture Capital* – the MDC has a subsidiary providing venture capital to MSC companies. Many companies report problems in finding finance for their projects.
- *Outlook* – most *SMEs* are not 'forward looking' and do not see the challenges posed by the rapid globalization process and changing ICT-technologies. Companies are also not aware of the changing business models, resulting from the technological advancement and globalization.
- *Innovation System* – innovation system and policy are weak to create incentives and motivation for the industry to go for innovations in a big way. This affects the firm/industry competitiveness.
- *Infrastructure and Client Services* – most companies are satisfied with the excellent physical and technological infrastructure in the MSC area. Client services rendered by the MDC are well recognized. Regular dialogue sessions between the MDC and IT-companies provide a good mechanism to link the Government and the private sector.
- *Ownership and Management Structure* – most IT Companies are under individual proprietorship, partnership or have private limited company status. Management structures are highly personalized, and in some cases, are run as family businesses. As such, management standards and practices vary widely. Well-qualified and dynamic k-workers prefer working in more modern and well-managed companies.

Firm Competitiveness in Malaysian IT Industry – Strategies for Enhancement

In this section, strategies and programmes are proposed to enhance the 'firm competitiveness' in the Malaysian IT industry. Some of the measures are of general nature and can be applied to other types of industries as well.

Financing Support

IT-based firms have peculiar financing requirements. High-risk new technologies/business ventures pose problems of uncertainty and are not easy to evaluate and select. Knowledge workers and *SMEs* who may come up with innovative project ideas have very little or no tangible assets to offer as collateral. Bank –based financing which relies on intensive project appraisal and tangible securities, does not suit the IT-innovators and business start-ups. Venture capital type of financing is more suited to them.

In Malaysia, venture capital markets exists, but are not as developed as the bank - based financing. Thus, there is a need to further develop the venture capital market and make it more receptive to new business ideas and ventures. Government support is essential to make the venture capital work for the benefit of the IT industry.

It is not only the availability of funds, which makes venture capital effective and useful to the Industry. It is the right attitude and high business and technical expertise, which make the venture capital institutions more effective and successful in achieving their mission.

Information Support

Globalization and the IT-based industries are going through constant change – technologies, products, markets, business environment, customer needs and preferences, are all changing. The technological and business information, at home and abroad, is vast and complex. The *SMEs* and local IT-based companies are handicapped by the lack of full information about their businesses and technologies. For *SMEs* to function efficiently and innovate, basic information on present and future developments is essential.

At present, the *SMEs* in the IT-industry are operating with limited information about international markets and technologies, which are in the offing. Firm's ability to develop competitiveness on a sustainable basis is adversely affected. To fill this gap, the government should take steps to conduct specialized/strategic studies with the help of experts and provide the relevant infomation to the industry for guidance. The public-private partnership in this endeavour would be very useful.

Innovation System and Policy

The Asian development model has emphasized factor accumulation and technology transfer (through capital goods, FDI and licensing) as a means of achieving economic growth. The model has been successful in generating high rates of GDP growth. But, in the long run, the Asian economic model may not generate economic growth unless factor productivity improves. Some analyst has rightly emphasized the need to shift the policy emphasis from factor accumulation to technical change, from emulation to innovation, and from perspiration to inspiration [3, p.15]. It is noted that the contribution of Total Factor Productivity (TFP) to GDP growth was only 20-36% in some of the Asian countries compared to 50-80% recorded for developed countries. The TFP comes from technology and technical change – which are the result of innovation activity.

Due to the development strategies of the past, most of the public sector institutions are geared to investment promotion. FDI and technology purchases received high priority. As a result, the indigenous innovation system and policy focus lagged behind. To advance the development process further, the need to improve the innovation systems is very urgent, as the globalization process does not help to take the developing countries to and across the technology frontier.

Malaysia also followed the Asian model and has shown excellent progress. Further impetus will however come by raising the TFP, through the development of science and technology and an efficient and effective innovation system. The need for a properly working innovation system is even greater in the IT-based industries, which are becoming more competitive with globalization and technological advancement. For this purpose, firm level and state level actions are required.

Education and Training

In the IT- related industries, the most important ingredient for success is the K-workers. Greater investments are needed in intangible assets (R&D, technology, managerial, entrepreneurial, and employee skills, business organization, market development, and software) to gain flexibility and long-term competitiveness [4, p.7]. The *SMEs* lack resources to invest in people, R&D, and market development. All of these investments have externalities, which makes it less attractive for a small firm to invest. The government should provide support to *SMEs* to undertake these activities and increase their intangible assets and further accumulate IT-related business knowledge. Special strategies and programmes should be evolved to help *SMEs* acquire knowledge and train their workforce.

The general education and training system should also be oriented towards 'quality' and 'specialized skills' needed by the IT industry. A strong link up between the IT-based industries and academic/training institutions is needed to further improve the standards and make education and training activity more relevant for the industry.

Networking & Alliances

Networking and business alliances are extremely important for developing countries in order to pool resources and create economies of scale. Regional and international networking and alliances are particularly useful in business and enterprise development, R&D activities, science and technology and market development. *SMEs* in the IT-related industry can greatly benefit from networking and strategic alliances for technology acquisition, R&D, learning, product development, and marketing. Regional blocs such as the ASEAN should cooperate in preparing member countries for global business development in key industries.

Search for Talent

Well-trained and skilled workforce is essential for the IT-based industries. Malaysia has earmarked substantial resources for education and training. The availability of IT graduates is quite easy. However, more skilled and experienced K-workers are in short supply. The government has adopted a relatively open policy on foreign technical and professional workers. This has helped the industry to meet its short-term requirements.

The industry also needs successful and dynamic entrepreneurs and IT-related experts. To attract this category of people, greater effort is needed to search for talent and offer adequate incentives to attract them on a long-term basis.

Role of the Government

The government has a crucial role to play in enhancing the competitiveness of firms and industry. Government should ensure that markets work efficiently and, in the case of any market failure, remedial actions are taken in time. Firms need clear and simple rules. A stable macroeconomic environment, efficient institutions, and elimination of red tape, are essential to creating a favourable business environment for the firms to operate and grow.

The government should rely more on the private sector and play only a facilitating role. In the context of IT industry, supportive role is needed in conducting studies and organizing consultancies, knowledge acquisition and development, export promotion, and strengthening education and training. Public-private sector partnership should be encouraged to meet the challenges of globalization. The government also has a role to encourage networks/alliances for the development of science and technology, human resources, and markets in the region and outside.

Institutions

The institutions relating to the development activity are geared to investment promotion, development administration and economic growth. Malaysia has already made significant progress in achieving these objectives. As a way forward, the development model for Malaysia should change in favour of building a science and technological base, innovation capacity, business development, exports, and human resources, and efficient markets. For this, the institutions need to change their orientation and strategies. Also the operational capabilities will have to be restructured and further strengthened.

Focus on the Firm

Business development strategies at the firm/industry level are generally lacking in developing countries. Most strategies and programmes are macro/sectoral in nature and aim at attracting investment or promoting industrial development. Fiscal and monetary policies are well suited to create a favouable environment for business and industry, but are inadequate to assist business development at the firm level. Since the firms in developing countries are not at par with MNCs in developed countries, it is important to introduce strategies and programmes to strengthen promising firms and promote well-selected businesses for the global market. Innovative programmes and strategies and new business support models are needed for this purpose.

TABLE 1: BASIC INFORMATION ON ICT COMPANIES SELECTED FOR STUDY

	Name	Employ-ment	Type of Business	Size	Market	R&D Facility	Ownership	Source of Technology
1	eSmart Systems Sdn Bhd (Malaysia)	15	Internet based business – E-commerce Service/ service providers	Small	Mainly local; some regional component (niche market – software for golf courses)	NIL	Private limited company	Own
2	Sapura Advanced Systems Sdn Bhd (Malaysia)	1,000	Group of companies - multiple business. ICT products services and	Large	85-90% local 10% foreign diversified business	R&D unit in each type of business	Private limited company	Own/ purchased

			solutions					
3	Lotus Engineering Malaysia Sdn Bhd	150	Design engineering	Medium	Mainly local	R&D company	Private limited company	Own/head-quarters
4	Smart Global Network (M) Sdn Bhd (Malaysia)	10	Internet service provider	Small	Local (niche market – value added services)	NIL	Private limited company	Vendors/ own
5	Xybase MSC Sdn Bhd (Malaysia)	300	Software development/ applications	Medium	80% local 20% foreign (niche market – airport IT)	R&D Section	Private limited company	Own/ partners
6	MIMOS Berhad (Malaysia)	1,000	Software development/ business applications	Large	90% local 10% foreign	Applied R&D	Private limited company	Own/ partners
7	Oracle MSC Sdn Bhd (USA)	150	Software development/ training/ consultancy	Large	Local	NIL	Private limited company	HQ/regiona l support

Appendix: Multimedia Super Corridor, Kuala Lumpur (Malaysia)

The Multimedia Super Corridor (MSC) was established in 1996 'to *provide a comprehensive world-class ICT-enabled working and living environment to catalyze the development of a knowledge-based economy'*. The enabling environment and incentives were designed to attract leading global web shapers to use MSC as a hub as well as spawn both local and foreign SMEs. Briefly, the Multimedia Super Corridor has the following features -

Vision: To make Malaysia as an ICT hub in the Region

Concept: A facility to attract dominant ICT firms and make it a place for facilitating the development of small and medium enterprises (*SMEs*).

Key drivers: World leading MNCs, local companies and start-up development.

Desired Outputs: High value jobs, export-driven growth, value created from new ICT ventures, and enhanced national productivity and competitiveness

Location: Kuala Lumpur - consisting of *five* cyber cities/centres, namely Cyberjaya, Technology Park Malaysia, University Putra Malaysia - Malaysian Technology Development Corporation (UUM-MTDC), Kuala Lumpur City Centre and KL Tower. Cyberjaya is designed and developed for living as well as working in a multimedia environment.

Facilities:

Physical-Infrastructure: World class physical infrastructure - roads, electricity, water, transport network (both road and air)

Technological Infr.-

- Fibre coverage of MSC
- Broadband services
- Performance guarantee
- Open multimedia network for easy interconnect
- Policy for universal access, local content development, equitable access to ICT products, life-long learning opportunities
- E-Village for multimedia and content development
- Internet Desa Programme
- R&D Centre

Financial - RM500 million ICT Fund MSC Venture Corporation (MSC-VC) established in 1999 to assist MSC-status and potential MSC-status companies (RM120 million)

Incentives:

- Competitive telecom tariffs
- 100% ownership for MSC status companies
- Unrestricted employment of local and foreign knowledge workers
- No internal censorship
- MSC infrastructure contracts for leading MSC companies
- MSC status companies to enjoy no income tax up to 10 years or 100 per cent investment tax allowance and no duties on multimedia equipment

Legal Framework:

- Copyright (Amendment) Act (1997) - protection of IPR
- Digital Signature Act (1997) - verification
- Computer Crimes Act (1997) - check the misuse of computers
- Telemedicine Act (1997) - framework for telemedical series
- Communications and Multimedia Act (1998) - regulatory framework for ICT industries

Flagship Projects:

Seven flagship projects were introduced to provide business opportunities for private sector participation and boost the quick development of the MSC.

- Electronic Government
- Smart schools
- Multipurpose cards
- Telehealth
- Research & Development clusters
- Technopreneur Development
- Borderless marketing (e-business)

Administering Agency: Multimedia Development Corporation (MDC). It serves as the 'one-stop super shop'.

MSC-status companies:

Number -	895 (23/9/03) 895 (23/9/03)	World class companies 45
Ownership -	Local 68%	Foreign 30% JV 2%

Technology Focus - Software Development
Internet-based Business
Content Development
Incubation/SI/Consult
Education & Training
Hardware Eng., Design
Others

		1997	2000	2003
Employment:	K-workers	1,946	9,842	18,290
	Total workers	2,190	11,911	21,270

Key Challenges: Sustaining MSC as a preferred location & regional hub for ICT development; continuous investment in HRD – key to long-term development; assisting companies to become globally competitive

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Reform Initiatives, Telecommunications and Economic Growth in Selected Asian Countries: An Econometric Analysis

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Abstract

Utilizing Granger-Causality tests within a panel cointegration framework, this paper examines the possibility of a two-way link between telecommunications infrastructure and growth in a panel of selected Asian countries. In addition, it investigates the role of telecommunications reforms, especially, privatization of state-owned Telecom providers, in explaining the aforesaid relationship.

The results of the analysis suggest that there exists, in Asia, a long run cointegrated relationship between the two variables of telecommunication infrastructure and economic growth after allowing for short run adjustments between the two variables. Also, for the entire panel of Asian countries, causality between the two variables appears to be bi-directional. The direction of causality, however, varies between countries with high and low degrees of telecommunications privatization. For highly privatized countries, the causality runs both from telecommunications to growth and growth to telecommunications. However, the two variables fail to reinforce each other for countries that are yet to achieve significant privatization. Causality for this latter group of countries runs only from telecommunications to growth reflecting a weaker income effect in the absence of privatization.

Introduction

The close link between public infrastructure investment and economic growth has been established in the literature since early 1980s[1]. In the recent past, Canning (1998) and Canning and Pedroni (1999) have fine-tuned the conclusions on this link by using sophisticated econometric techniques that rules out the possibility of spurious correlation between the variables. Having reached a consensus on the positive growth impact of public infrastructure investment, scholars and researchers are now shifting their attention to one specific component of infrastructure investment, namely, telecommunications investment, with the expectation that the growth impact of telecommunications infrastructure investment will be much higher compared to that of any other type of infrastructure investment. Based on the findings of the existing literature, it is now widely believed that telecommunications infrastructure investment drives economic growth by creating network externalities, reducing transaction costs, and increasing productivity. In addition, it enhances growth by generating demand for telecommunications related products and services[2].

While there are quite a few studies on telecommunications infrastructure, only a few of those have critically examined the impact of telecommunications investment on growth measured in terms of real GDP (GDP from hereafter). The rest of the studies, places more emphasis on examining the impact of telecommunications reforms on its performance. The branch of the literature directed towards telecommunications impact of growth including Roller and Waverman (2001), Greenstein and Spiller (1996), Lichtenberg (1995) and Norton (1992) suggest that investment in telecommunications infrastructure impacts GDP significantly. Being devoid of a stationarity test on the time series used in these analyses, such results, however, are not indicative at all of a causal link between the two variables of Telecommunications investment and GDP. None of the cited studies except Roller and Waverman (2001) chose to address the issue of a possible causal link. In examining the link, the latter study utilized a joint equation system that endogenizes the telecommunications investment. The findings of the study suggest that there exists a one-way causal link between the two variables running from telecommunications to GDP. Further, the results indicate that the strength of the causality is dependent on the presence of a critical mass of telecommunications infrastructure in the study region or country.

The branch of the literature directed towards examining the impact of telecommunications policy includes the following. Fink, Mattoo, and Rathindran (2002), Wallsten (2002; 2001; 2000; 1999), Li, Qiang and Xu (2001), Boyland and Nicoletti (2000), Li and Xu (2000), Noll (2000), Petrazzini and Clark (1996), Wellenius and Stern (1995), and Megginson, et al (1994). Evidence from these studies suggest a strong association between competition and telecommunications performance measured in terms of number of telephone mainlines, connection capacity and price of telephone service. The findings on the effect of privatization of telecom providers are mixed. While many find that privatization lead to significant improvements in telecommunications service, a few suggest that privatization without regulation fails to improve performance. The latter group, however, finds a significant association between privatization and performance when privatization is combined with independent regulators.

While all the cited studies provide important insights into the relationship between telecommunications investment, GDP and reform efforts, they reflect no serious efforts in understanding the two-way causality between telecommunications investment and GDP. The two-way causality stems from the fact that while telecommunications investment enhances economic growth through network externalities, increased growth creates demand for telecommunication access through income effects. This paper takes the first step in exploring the two-way causality between telecommunications infrastructure and GDP for a panel of 12 Asian countries. A panel cointegration technique developed by Pedroni (1995, 1997) provides the analytical framework for this investigation. The chosen framework allows for a test of long run cointegrated relationship between telecommunications infrastructure and GDP and provides an error correction model to capture the causal link between the cointegrated variables. Taking note of the fact that most of the developing countries, including the Asian economies, have undertaken serious privatization efforts in their telecommunications sector since late 1980s, the paper also examines the changes in the causal relationship between the referred variables, if any, under high and low degree of privatization.

The results of the cointegration analysis suggest that telecommunications infrastructure and GDP are indeed cointegrated in the long run. A classification of countries with high and low share of private holdings in the telecommunications sector yields that the causality between telecommunications infrastructure and GDP are bi-directional for the countries with high degree of privatization in the telecommunications sector. For countries with low degree of privatization, causality runs only from telecommunications infrastructure to GDP. This evidently suggests that by keeping the income effect weaker, lack of privatization efforts prevents telecommunications infrastructure and economic growth to reinforce each other.

The rest of the paper is organized in the following manner. The section that follows discusses the data set utilized in the analysis. Section 3 presents the broad trends in the growth rates of telecommunications infrastructure and GDP for the selected panel of countries. Section 4 reports the results of the empirical analysis. A brief conclusion is included in section 6.

Data Description

The panel used in this paper includes 12 Asian countries and the study period spans from 1975 through 2000. A sub-regional breakdown of these countries is given in table 1. As is evident from the table, the list includes all the developing countries in the Asian region except, Vietnam, Cambodia, Myanmar and Nepal. To keep symmetry in the data set, these countries were excluded from the study list. The relevance of the chosen time period for the data set lies in its ability to capture the transition from nationalized monopoly telecommunications firms to partial or full privatization telecommunications sector holdings.

The variable telecommunications infrastructure in the data set represents mainlines access per 100 inhabitants, or teledensity rate (TDR hereafter)) as it is popularly known. TDR essentially measures the stock of telecommunications infrastructure as opposed to telecommunications investment. However, traditionally, the use of TDR is preferred over telecommunications investment because as suggested by Roller and Waverman (2001), “consumers demand telecommunications infrastructure, not telecommunications investment per se”. The GDP series represents annual real GDP measured in 1995 Dollars. Annual series for TDR and GDP for each of the countries and for each of the referred years have been collected from the World Development Indicators data base published by the World Bank in 2001.

TABLE 1: LIST OF ASIAN COUNTRIES

Sub-Region	Countries
East Asia	China Hong Kong Korea
South East Asia	Indonesia Malaysia Philippines Singapore Thailand
South Asia	Bangladesh India Pakistan Sri Lanka

Degree of privatization in the telecommunications sector has been measured with shares of private holdings in telecommunications firms in each country. Available data indicate that the average share of private holdings in the telecommunications sector is about 40 % in the Asian region. Consequently, countries with higher than 40% holdings have been categorized as ones with highly privatized telecommunications sector; countries that reflect less than 40% private holdings have been identified as those with non-privatized telecommunications sector. The data on private shares in the Telecommunications sector have been collected from the International Telecommunication Union or ITU for short.

Broad Trends in Telecommunications Infrastructure and Growth

Utilizing the data set, estimates for annual average growth rates of real GDP and TDR have been computed to summarize the trends in the selected countries. Table 2 reports the sub-period breakdowns of the growth rates for these two variables. In order to examine the impact of telecommunications reforms over the past two decades while controlling for the Asian Crisis, the study period has been divided into the following three sub-periods; 1975-1985, 1985-1995, and 1995-2000.

TABLE 2: GROWTH RATES OF GDP AND TDR FOR ASIAN COUNTRIES (PERCENTAGES)

Countries	GDP			TDR		
	1975-1985	1985-1995	1995-2000	1975-1985	1985-1995	1995-2000
China	8.14	10.13	8.62	0.11	2.76	14.88
Hong Kong	8.04	5.90	3.59	12.08	20.23	10.22
South Korea	6.76	8.30	5.62	11.80	24.86	16.90
Indonesia	6.18	7.14	5.57	0.19	1.23	3.08
Malaysia	6.33	7.45	5.70	4.34	9.99	8.92
Philippines	2.24	2.49	3.75	0.25	1.01	3.92
Singapore	6.72	7.85	6.66	18.30	12.17	14.75
Thailand	6.11	9.06	1.92	0.65	4.53	7.32
Bangladesh	4.35	4.22	5.16	0.06	0.12	0.22
India	3.91	5.76	6.06	0.16	0.83	3.57
Pakistan	5.91	5.53	3.44	0.17	1.09	1.20
Sri Lanka	4.64	4.48	5.12	0.21	0.57	5.07
Average	5.78	6.53	5.10	4.03	6.62	7.51

The data indicates that the stock of telecommunications infrastructure grew at a rapid pace throughout Asia since 1985 recording an average growth rate of 6.62 and 7.51 percent for 1985-1995 and 1995-2000 respectively. Also, average GDP growth rate reached its peak at 6.53 percent during the period 1985-1995. The reduced growth rate of 5.10 percent in the following period is perhaps indicative of the deleterious effect of the Asian Financial Crisis. It is interesting to note that despite this reduced growth rate, TDR recorded its highest growth rate during the same period. Whether this paradox can be explained by the increased internal efficiency resulting from intense privatization efforts undertaken by the selected countries during this period remains yet to be tested.

Overall, real GDP for the Asian countries reflects a strong positive association with TDR. The correlation coefficient between the two variables is 0.98.

Empirical Results

As has been mentioned at the outset, the positive association between GDP and TDR referred in the earlier section can be misleading because of possible unit roots in the two variables. To test the nature of association between the two variables while avoiding any spurious correlation, the empirical investigation in this paper follows the three steps suggested in Basu, Chakraborty and Reagle (2003). We begin by testing for non-stationarity in the two variables of GDP and TDR. Prompted by the existence of unit roots in the time series, we test for long run cointegrated relation between two variables at the second step of estimation using the panel cointegration technique developed by Pedroni (1995, 1997). Granted the long run relationship, we explore the causal link between the two variables by testing for granger causality at the final step.

Test of Unit Roots

The panel data technique referred above has appealed to the researchers because of its weak restrictions. It captures country specific effects and allows for heterogeneity in the direction and magnitude of the parameters across the panel. In addition, it provides a great degree of flexibility in model selection. The included alternatives range from model with a constant and a deterministic trend to model with no constant and no trend. Within each model there is opportunity to test for common time effects.

Following earlier works in the literature we test for both trend stationarity and mean stationarity for the two variables of GDP and TDR. Also, we control for time effects common to all countries (t= 1975-2000) within each model. Consequently, the models of interest are: model with a trend and common time effect (M1); model with a trend and no time effect (M2); model with no trend and common time effect (M3); and, model with no trend and no time effect (m4). With a null of non-stationarity, the test is a residual based test that explores the performance of four different statistics. Together, these four statistics reflect a combination of the tests used by Levin-Lin (1993) and Im, Pesaran and Shin (1997). While the first two statistics are non-parametric rho-statistic, the last two are parametric ADF t-statistics. Sets of these four statistics for each of the four models examined have been reported in table 3.

The first two rows under each model report the panel unit root statistics for GDP and TDR at the levels. Given that the left tail of the normal distribution is used to reject the null hypothesis, the positive values reported in these rows consistently fail to reject the null across different models.

The last two rows under each model report the panel unit root statistics for first differences of GDP and TDR. The large negative values for the statistics indicate rejection of the null of non-stationarity at 1% level for all models. It may, therefore be concluded that the two variables of GDP and TDR are unit root variables of order one, or, U (1) for short.

Test for Panel Cointegration

At the second step of our estimation, we look for a long run relationship between GDP and TDR using the panel cointegration technique developed by Pedroni (1995, 1997). This technique is a significant improvement over conventional cointegration tests applied on a single country series. While pooling data to determine the common long run relationship, it allows the cointegrating vectors to vary across the members of the panel.

The cointegration relationship we estimate has the following specific form.

$TDR_{it} = ?_{i} + ?_{t} + ?_{i}\, gdp_{it} + ?_{it}$ (1)

Where ? $_i$ refers to country effects and ? $_t$ refers to trend effects. ? $_{it}$ is the estimated residual indicating deviations from the long run relationship. With a null of no cointegration, the panel cointegration test is essentially a test of unit roots in the estimated residuals of the panel. Pedroni (1997) refers to seven different statistics for this test. Of these seven statistics, the first four are known as panel cointegration statistics; the last three are group mean panel cointegration statistics. In the presence of a cointegrating relation, the residuals are expected to be stationary. A positive value for the first statistic and large negative values for the remaining six statistics allows rejection of the null of no cointegration. All of these seven statistics under different model specifications are reported in table 4. The statistics for all different model specifications suggest rejection of the null at 1% level. We, therefore, conclude that the two unit root variables TDR and GDP are cointegrated in the long run.

TABLE 3: TEST OF UNIT ROOTS FOR GDP AND TDR

Variables	Levin-Lin Rho-stat	Levin-Lin t-Rho-stat	Levin-Lin ADF stat	IPS ADF stat
Model: M_1				
TDR	4.4206	1.6140	-0.5681	0.5127
GDP	2.7537	0.9327	0.4423	1.4281
?TDR?	-28.8651	-12.7398	-18.3532	-34.8469
?GDP	-27.81345	-13.8114	-15.6319	-30.6562
? Model: M_2				
TDR	2.5174	0.7872	-0.0125	0.3559
GDP	4.0803	1.2207	1.0332	1.9644
?TDR?	-29.2004	-13.9773	-23.3832	-41.9140
?GDP	-32.2714	-15.7722	-20.3881	-41.2205
? Model: M_3				
TDR	3.8828	5.7754	2.3451	2.7184
GDP	2.5726	3.4217	3.2970	4.4954
?TDR?	-16.5798	-17.7934	-36.5501	-74.1512
?GDP	-25.6068	-28.3155	-31.1493	-68.1030
? Model: M_4?				
TDR	1.8458	1.9410	1.3221	1.3796
GDP	2.5726	3.4217	3.2970	4.4954
?TDR?	-16.5798	-17.7933	-36.5501	-74.1512
?GDP	-25.6068	-28.3155	-31.1493	-68.1030

TABLE 4: RESULTS OF PANEL COINTEGRATION TEST

Statistics	Model:M1	Model: M2	Model:M3	Model:M4
Panel v-stat	1.4109	2.7498	3.2054	5.9994
Panel Rho-stat	-4.8648	-3.2847	-4.7563	-4.2935
Panel PP-stat	-5.5757	-4.3659	-4.1006	-3.4426
Panel ADF-stat	-5.2180	-5.5575	-3.1300	-4.0745
Group Rho-stat	-2.6882	-1.5018	-3.6279	-3.2356
Group PP-stat	-4.4023	-3.8135	-3.6937	-3.4528
Group ADF-stat	-4.0749	-5.8136	-3.0426	-5.1491

Test of Causality

The panel cointegration test reported above simply suggests that GDP and TDR are cointegrated in the long run. It does not reflect any causal link between the two variables. Neither does it offer any indication about the direction of such causal link. At the third and final step of estimation, we utilize an error correction model to test for Granger causality in the long run relationship following[3].

Granger causality itself is a two-step procedure. The first step relates to the estimation of the residual from the long run relationship. Incorporating the residual as a right hand side variable, the short run error correction model is estimated at the second step. Defining the error term from equation (1) to be e_{it}, the dynamic error correction model of our interest has the following form.

$$? TDR_{it} = ?_{1i} + ?_{1i} e_{i\,t-1} + ??_{11i} ? TDR_{i,t-1} + ?_{12i} ? TDR_{i,t-2} + ?_{13i} ? GDP_{i,t-1} + ?_{14i} ? GDP_{i,t-2} + u_{1it}$$

$$? GDP_{it} = ?_{2i} + ?_{2i} e_{i\,t-1} + ??_{21i} ? TDR_{i,t-1} + ?_{22i} ? TDR_{i,t-2} + ?_{23i} ? GDP_{i,t-1} + ?_{24i} ? GDP_{i,t-2} + u_{2it} \qquad (2)$$

As is evident from equation (2), the chosen vector error correction model involves k=2 lags. The parameters in equation (2) have important long run and short run implications for our purpose. The implications are as follows.

$?_{1i}$ = long run effect of GDP on TDR

$?_{2i}$ = long run effect of TDR on GDP

$?_{13i}$ and $?_{14i}$ = short run Granger Causality running from GDP to TDR

$?_{21i}$ and $?_{22i}$ = short run Granger Causality running from TDR to GDP

While the long run effects define movements along the path of a steady state equilibrium relation ship between GDP and TDR, the short run impacts simply reflect how the variables adjust in response to a random shock. Stated differently, the short run effects show how each variable in the defined cointegration model responds or corrects itself to the residual or error from the cointegrated relation. In this sense, the short run effects are transitory. Following Basu, Chakraborty and Reagle (2003) we use a standard F test to estimate the error correction model defined in equation (2). With a null of no causality, the precise direction of Granger Causality can be detected by using the F test to determine how significantly the coefficients for the above referred parameters differ from zero.

TABLE 5: RESULTS OF FULL PANEL CAUSALITY TEST

Null Hypothesis	Long-Run	Short-Run
Ho: GDP does not cause TDR	F=2.58	F=2.68
Ho: TDR does not cause GDP	F=10.2	F=1.77
Critical Value	F critical=1.55	F critical =1.38

The results of the F test for both long run and short run causality are reported in table 5. As is apparent from the table, the null hypotheses of no long run causality and no short run causality for the two cases considered are rejected at the 1% level. The full panel reflects bi-directional causality between GDP and TDR for both long and short run.

Impact of Privatization in the Telecommunications Sector

Although the full panel reflects bi-directional causality, the nature and direction of causality are likely to vary between the members of the panel that differ in terms of attained degree of privatization in the state-owned telecommunications sector. To capture the impact of varying privatization efforts, if any, we create sub groups of countries with high and low degree of privatization at the final stage of our analysis. The sub groups are defined on the basis of an index of privatization. With data on share of private holdings for developing countries, we computed a developing country average of private share by weighing the shares with individual TDRs.. We then formed the sub groups of countries with high and low degree of privatization by identifying the former group as one with countries reporting higher than the average share of private holdings.

The two-step Granger Causality test was repeated for each group of countries to detect the differential impact of privatization. The results of the tests are reported in table 6. The reported results do show difference in long and short run causality between the two country groups. For countries with a high degree of privatization, the causality is bi-directional both in the short and long run. For countries with a low degree of privatization, causality runs only from TDR to GDP. While there is a weak causality from GDP to TDR (at the 10% level) in the short run, long run causality in similar direction is rejected at all levels.

Table 6: PANEL CAUSALITY TEST WITH INDEX OF PRIVATIZATION IN TELECOMMUNICATIONS SECTOR

Null hypothesis	High degree of privatization		Low degree of privatization	
	Long Run	Short Run	Long Run	Short Run
Ho: GDP does not cause TDR	F= 4.61	F= 2.71	F=0.21	F= 1.55
Ho: TDR does not cause GDP	F=6.78	F= 1.84	F=6.99	F=2.47
Critical Value	F critical= 2.79	F critical=2.19	F critical = 3.17	F critical = 2.07

Conclusion

The link between telecommunications infrastructure and economic growth is gaining increasing importance in the literature. While many researchers have documented the link, the direction of causality between the variables has rarely been addressed. Utilizing Granger Causality within the framework of a panel cointegration model, the results of this paper suggest the existence of a long run equilibrium relation between GDP and TDR for a panel of Asian countries.

The presence of the cointegration relation raises the question about the direction of causality between the two variables and its long and short run dynamics. This paper uses the two-step Granger causality test to address that issue. Results from this test indicate that the causality for the full panel is bi-directional in the long run as well as in the short run. To gauge the impact of privatization efforts undertaken by the panel members since late 1980s, the paper repeats the Granger Causality test for created country subgroups identified by high and low degree of privation. The results from the repeat Granger causality test indicate that for countries with high degree of privatization, causality is bi-directional. For countries with low degree of privatization, causality runs only from TDR to GDP.

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End Notes

[1] A comprehensive survey of the literature on infrastructure investment is offered in Alicia H. Munnell (1992) and Edward M. Grammlich (1994).
[2] See Roller and Waverman (2001).
[3] Basu, Chakraborty and Reagle (2003) used similar Granger Causality test for examining the direction of causality between foreign direct investment and GDP for a panel of developing countries.

Issues and Challenges of The Malaysian Internet Payment System

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Abstract

The Internet Payment System (IPS) is the latest means of doing financial transactions over the Internet. However, its inefficient usage among Internet users has become a prime hindrance for Malaysian utilizing the IPS despite the advantages and benefits it generates for users. Although many efforts have been made to make this as a secure and practical payment system, the use of IPS in Malaysia is decreasing. This paper discusses the issues and challenges of the IPS industry in Malaysia. Expected issues and challenges on IPS can be classified as customer, merchant, IPS provider, Internet service provider, financial institution and the government. A case study on the Cybank, an IPS pioneer in Malaysia, was done using the simulation modeling to evaluate the Cybank performance.

Introduction

There is no question that electronic commerce is changing the way we work and live, but is it making the economy more efficient? According to [8], e-commerce could have an overpowering effect on Malaysia's economy. To be more specific, in this Internet era, Malaysia could be at a more competitive edge when dealing with Internet businesses or Internet commerce. [7] Also said that like other major technological breakthroughs of the past, Internet commerce has the potential to bring the market economy a step closer to its theoretical potential.

IPS is any conventional or new payment system, which enables financial transactions to be made securely from one organization or individual to another over the Internet [8]. IPS is represented in digital form when commencing a transaction over the Internet, after the actual cash has been credited into one's Internet account. Digital form is also known as digital money or e-cash. A customer who can be an individual or a company, and is interested to do online financial transaction or shop on the Internet, must be connected either to an IPS supplier's website or a merchant that uses an IPS on his website. This means the website must be commerce-enabled. Both the customer's and merchant's request to clear the transaction will be handled by a third party or system better known as the IPS.

The benefits of utilizing the IPS, which stands, as an interactive mean of doing financial transactions through the Internet are convenient to use, can be done anytime from anywhere and is becoming more secured from time to time. It is also the new way of integrating commercial services to an electronic marketplace, which is the Internet, especially for small and medium enterprises (SME) to compete at the international level.

The benefits again are partitioned into three categories: advantages of payment distribution, online financial communication and easier financial operation. For instance on the advantages of the payment distribution, a greater availability of uncommon purchases, exotic, international products not sold locally [9] can be done despite the geographical factor. The purchases can be done online without having to think of the communication barriers like the time zone or working days that these suppliers may not be around. Easier financial operation would mean that the management of a specific product account is done automatically by the IPS although there are many products that are displayed on the website. Besides those services, the IPS is also a mean for private purchases and small amount of purchases (micropayment) unlike the usage of credit cards, which has a minimum amount to use.

This paper reviews the issues and challenges that will occur on the entities that make up the IPS industry while using the IPS. A case study on the Cybank was done using simulation modeling to evaluate the performance of its IPS. This paper is organized as follows. Section 2 describes the IPS in Malaysia while the case study on Cybank is explained in section 3. Section 4 provides the issues and challenges of the IPS followed by conclusion in section 5.

Internet Payment System in Malaysia

There are about 2.2 million Internet users throughout Malaysia and this number will grow exponentially with time [1]. This implies that about 10% of the Malaysian citizen uses the Internet and are computer literate and their capability to compete in this globalization era. An efficiency survey on the usage of IPS, which was conducted on 2,200 potential Internet shoppers by [3], shows that only 10% of the sample is utilizing this facility. This indicates a low awareness about the benefits of utilizing the IPS among them. The other 90% of the sample are still in impediment towards the idea of changing to a more convenient way of doing financial transactions. Several reasons have been highlighted in respond to this aversion and among them are the unsecured reasons, slower response time and non-automated authorization procedures that have to be executed manually or off-the-Internet to execute a transaction. Time is gold to these potential IPS users although they know that the procedures taken by these IPSs are important to secure a transaction, but this performance degradation will demoralize them. If this scenario continues, Malaysia will not be able to generate a faster domestic sector that can enhance the economy due to lack of usage and investment, although the Malaysian Budget for year 2002 has reported that the government will take firm actions to ensure domestic demand is fulfilled [6].

An example of an IPS pioneer in Malaysia is the Cybank system that is being managed by Oxford Media Sdn. Bhd., a subsidiary of Sateras Berhad. The customer, the merchant and the IPS are connected through the Internet, which is being handled by Internet service provider (ISP). There are a few ISPs that provide Internet connection in Malaysia and among the gigantic ones are Telekom Malaysia Berhad and Mimos Berhad.

Besides communication through the Internet, transaction off-the-Internet also occurs when the IPS is linked directly to the Intranet of a back-end banking system or a credit card system. This is due to the security procedures that must be followed in order to protect forgery of credit cards or intrusion of banking instructions. This off-the-Internet transaction is a 'must phase' for customers who wants to deposit his/her money in an Internet account. A better illustration on how the IPS works in the e-commerce industry in Malaysia is shown in Fig. 1. However, this diagram does not apply to other countries because their IPS can easily be connected to the banking systems through the Internet and their IPS vendors are also willing to take the risks of charge-backs if credit card forgeries occur.

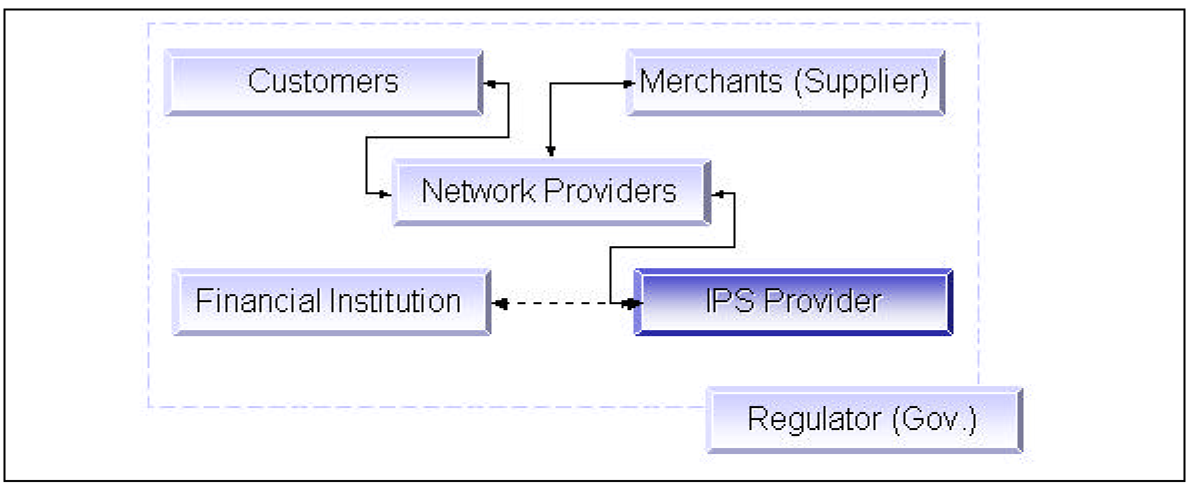

FIG. 1: GENERAL FLOW OF THE INTERNET COMMERCE INDUSTRY

The diagram also shows the responsibility of government in controlling and monitoring the flow of the whole Internet commerce industry either transparently or indistinctly.

The Cybank System Case Study

Cybank offers a global IPS that includes five services namely opening an account, adding cash, purchasing, transferring and withdrawal. With all the security guarantees and benefits that can be gained from Cybank, expectations were high that Malaysian public would favourably utilize Cybank. However, Cybank management reports that the usage of Cybank is on the decreasing. The need to find out the problem is important in order to improve its performance thus attracts more customers. Therefore, a simulation model was built to understand its potential and very nature. Simulation has been proven as a reliable modeling method that can imitate the behavior of complex transaction system as the IPS and this is also to avoid from tampering with the actual Cybank system.

The simulation model was designed and built in Arena. The model contains five subsystems, where each subsystem represents one of the five services offered. Data used was collected through observation and from historical records. The accuracy of the built model was validated where the simulated output was compared with the actual data. Table 1 shows the output of the throughput using simulation compared with the historical data and it seem that they are in good agreement. The higher difference for the withdrawal case is because the value is considered small and therefore creates a high percentage value.

The simulation output reveals that the adding cash section has the worst problem where the bottleneck seems to occurs. The average time taken at this section is 60.98 hours to do bank transfer request. This section is not automated yet, where it served by 2 customer service staffs. Their job is to inspect manually with external banks on the deposit that has been declared transacted by the customer via the given transaction identification. The task usually takes very long to complete because it has been done manually. The resource utilization indicates a value of 0.95.

Withdrawal on the other hand takes about 13.6 minutes. Purchasing department on the other hand takes only 3.34 minutes to complete while transfer request only required 1.3 minutes.

TABLE 1: DIFFERENCE OF THROUGHPUT BY CYBANK MODEL & HISTORICAL DATA

Service Type	Simulation Output	Historical Data	Difference (%)
Open Account	575	560	2.608
Transfer	140.41	150	6.825
Purchase	851.42	840	1.341
Withdrawal (Bank)	8.41	7.2	16
Add Cash (Bank)	33.16	35	5.527

The simulation shows that the Cybank system experiencing a serious bottleneck at two section, i.e. add cash and withdrawal. The problems at add cash will not resolve unless the section will be automated and not done manually as practice currently. Interpretation of the simulated output on the performance of the Cybank system indicates low utilization of the resources. Customers have to spend a long time due to Internet's response time and the lengthy adding cash processing time. As a result users were not motivated in utilizing the system due to its bad performance. To overcome this setback, we must look at the issues and challenges that must be faced by every entity that are related to the IPS industry.

Issues and Challenges

As Internet businesses continue to grow, profound effects in method of payment and economic theory and policy will rise. By 2003, experts of the United States of America estimate that electronic commerce will comprise 10% of their GDP. Further, they predict that Internet business activity will continue to increase after that [11]. The same will most probably happen to Malaysia since our economy is also affected by the USA's economy. The expected issues and challenges on IPS can be classified as customer, merchant, IPS provider, ISP, financial institution and the government.

Customer

Malaysian citizens or foreigners that have had exciting and satisfactory experience while using the Malaysian IPS should continue to use this service because they are the main contributor to a faster-growing economy. The domestic and foreign demand can be catered in more effective and efficient way. These individuals should start telling others the advantages of spending more and faster with the IPS, besides being able to create productive and knowledgeable Malaysian citizens.

However, for those who have had bad experience using the Malaysian IPS either concerning trust, security and privacy or too much hassle while operating it, should start sending comments directly to these IPS vendors to ensure that their services is upgraded to cater the responsive needs of the customers. The fear to continue using the IPS will give a negative impact because reduction to an accelerated economy will take place.

For those who have not had any experience and would like to try using the IPS, should always ensure that the company operating the said IPS are local companies, so as to ensure that their transaction is in safe hands. For these potential IPS users, the government's support or recommendation would mean a safer try-out for them.

For individuals that want to add cash into their IPS account but do not have credit cards, using the IPS seems like a no entry zone to them. However, there are other alternatives that have been offered and among them are the use of cash, bank transfers and other deposit means. When customers are occupied with easier means to use the IPS, more customers will be willing to use this great facility and purchase anything on the Internet as seldom or whenever they want. Having the privacy to purchase any extraordinary thing adds the need to utilize the IPS.

There are customers that do not know where to use these IPSs. In other words, the website that offers the same IPS that the customer is using is unknown to the customer. However, there are good IPSs which is locally managed by Malaysian companies that state the merchants' URL addresses for the convenience of its customers and as a value added service to every merchant in promoting their website.

Merchant

While using the IPS will add promotion to their website, the fear of incurring high cost pertaining to the use of IPS always occur. The total amount of paying a marketing, sale and accounting staff is more than the cost of doing business on the Internet itself. Internet commerce reduces the sales cost for such companies to negligible proportions like the cost of a storefront, middleman and other accrued cost that can be bypassed. Additionally, sales tax has not been present and is still an open issue in some countries [4]. Adding to this great news, recently the Malaysian government announced a waive of 10% tax on SME that does Internet business. The Prime Minister who is also the Finance Minister has suggested that Malaysia is lucky for having diversified economical structure [6] where the marketing and selling effort for all types of businesses can be applied on the Internet. Consequently, local companies that ventures Internet commerce will achieve higher profits.

This method of doing sales and marketing at the customer's leisure, insures that marketing will not be wasted on uninterested customers since it can be assumed that anyone who finds the website for a specific product has a predisposed interest in the product. In addition, collection of payment, which can be done online using the IPS will secure this selling point [9].

The IPS also facilitates micro payment services. This means even a one-cent product can be sold on the Internet without having to think on the effort that must be put into those minor transactions. Merchants will also have better account management since a product account is created automatically for every product that is displayed on the merchant's website.

An attractive commerce-enabled website with a good IPS must be built. Many problems in setting up a commerce-enabled website will occur but many local IPS vendors are willing to do it at a minimum cost or even free for these merchants. This initial investment for its set up and minimal overhead for its maintenance will make the business relatively cost effective.

More investment can be done to upgrade the quality of offered products or services so that the Malaysian merchants can be at par with other international suppliers. Furthermore, the operational costs of most Malaysian-made products are lower compared to other countries. Its uniqueness gives a better advantage for the Malaysian merchants to sell their products and secure international business. Foreign and local customers will have access to a greater variety of goods and services, greater ability to compare prices and paying it in order to secure an order [5].

This excellent and structured way of marketing, selling, collecting payment and managing accounts through the Internet is a must technology for Malaysian merchants. This will secure their Internet business, which includes penetrating the global market. Malaysia will have a boost in its economy since the local and foreign demand and supply chain will increase when exchange of cash between entities becomes more intense and the flow of foreign currency into our country also increase.

Internet Payment System Provider

Looking at the customers' and merchants' need which must be fulfilled, it is clear that these IPS provider must ensure that priority to enhance the areas of trust, security and privacy is very high. Hence, to develop trust for an IPS would simply mean involving unproblematic repetition of a process [2], such as when adding cash into an IPS account, which has been proven time consuming from the built Cybank simulation model. Although the off-the-Internet communication part is for security purposes, this will eventually create service dissatisfaction due to the time consuming factor. In other words, if a person can easily operate the IPS without adverse consequences, he/she will be more likely to use the IPS again. Therefore, building confidence in IPS consumption ultimately links to the issue of security, or ensuring a flawless transaction processing. In addition, the many ways of adding cash into an Internet account besides the usage of credit card must also be catered to promote the usage of IPS for non credit card holders.

The effort to link IPS directly to banks would be one of the solutions. A stronger and more distributed local IPS, can be generated and utilized at the international level. Here, the IPS provider itself will gain profit from the small charges that they make from the high usage of its system. As more business transaction takes place on the Internet, higher demand on the most comprehensive IPS will rise. Thus, more research and development must be done to ensure the continuation of a world-class quality IPS besides overcoming the intermittently rising problems. Other countries have fully automated the flow of Internet commerce it shouldn't be a problem for local IPS to follow, unless it involves the rules and regulation that the Malaysian government has stipulated. Obviously investment in this area is high but with the help of local academic institutions and private sectors that carry out research in this area, things will be simpler. More skilled Malaysian workers must also be employed to maintain and do enhancement work on the IPS.

Internet Service Provider

The exponential growth of Internet users in Malaysia will become faster as the need to utilize the IPS grow when every Malaysian realizes the benefit and advantage that he/she can gain from the IPS. More potential customers will access the Internet to shop, pay utilities or do financial transfers and more businesses will start venturing the Internet, build their website and utilize the maximum space that a hosting server allows. As a result, communication back and forth through the Internet will increase, in and out of the country, so the need of a higher bandwidth will be necessary to cater the responsive needs of these entities.

ISP will gain more business when more bandwidth is used and created thus generating a faster economy when they have to spend more on the effort of laying more cables, getting more communication and technical workers and enhancing the capability or usability of those bandwidth. Additional servers has to be purchased for the rising demand of hosting services due to the increasing number of businesses that venture Internet commerce. More money has to be spent and this obviously requires larger capital hence comes the need of loans.

Financial Institution

Banks should be more approachable and receptive when application of loans are submitted, with regards to the need of upgrading physical technological infrastructure which will help in the development of a more knowledgeable and efficient society. The chain of purchasing and selling by the customers and merchants and from the need of a better bandwidth will obviously profit the bank thus creating a faster growing economy.

Banks and credit card companies should also take the challenge of hooking their financial system to the Internet through these IPSs, though immense investment has to be done on restructuring the operations of their financial system, which involves gaining license from the National Bank of Malaysia. The logic is that, the IPS, which also has very reliable and proven security will be able to act as a firewall between the back-end of the financial system and the Internet, when considering the high possibility of Internet threats and attack. Consequently, the time consuming factor when customers request to withdraw physical cash from their bank accounts or credit cards, and add them into their Internet accounts, can be minimized due to the automatic clearance that can be done on the Internet itself. This tremendous change will create extraordinary interest among Malaysians especially those without credit cards, to explore the IPS and do financial transactions over the Internet. But most importantly is the government's role in ensuring that the usage of IPS will give a better impact to the economy.

Government

Being the citizen of Malaysia that trust and support its government, any recommendation or suggestion by the higher authorities will be pursued. For that reason, it is very important for the Malaysian government to study, support and recommend the use of IPS, which could trigger public's interest. However, there has been little guarantee or support from the Malaysian government on the security or capability of these local IPSs. As a result, the distribution of these IPSs are not widespread and are not recognized by banks making it worse for these IPS vendors to maintain this excellent technology and do wondrous enhancement on it. Therefore, government has to learn this technology and invest in promoting the benefits of IPS to the public through advertisement or education. Electronic or printed media can be used to convey theoretical input while practical training on government servants must be done as pilot implementation. Either administration staff or the laborers, every unit must be supplemented with this type of knowledge to operate the government's financial system, which will also be hooked up to the IPS. Besides being efficient in managerial matters, the accounting unit's burden to track the account is also lessen thus they would be able to look at other important accounting matters. As more government people start to use the IPS, the efficiency and productivity of our government will become better thus part of the electronic government flagship from the Vision 2020 can be achieved.

More research and development in the security, privacy and other IPS area must also be done, as government prepares scholarships for academician or students of local and private universities.

Conclusion

The unique benefits of the IPS make Internet an indispensable medium for commerce today. The Internet, which acts as a virtual marketplace is an arena for the exchange of both information and goods while the IPS secures the financial transactions that is done though it. The significance of this study comes in seriously for Malaysia since we know that communication through the Internet is an intrinsic part of any Internet business transaction. Furthermore, all statistics forecast a growth in Internet businesses. As Internet commerce begins to have a larger contribution to the overall consumption of the world, economic institutions will profoundly change. The changes in methods of payment, the science of economics, and the ways government can control Internet commerce will now be considered.

A more knowledgeable and productive society will also emerge through the six entities that contribute to the growth of Internet commerce. The IPS's societal importance on the Internet commerce industry will drive Malaysians to establish organizations, laws and currency necessary to secure the safety and efficiency of economic activity. In return, Malaysia will be able to benefit from the vast growth of a promising future and ensure Malaysia's survival in the rivalry globalization and liberalization era.

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The Mexican E- Consumer: An Examination of the Key Factors in the Buying Process

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Abstract

In Mexico, established businesses have started to implement electronic commerce as a way to add value to their marketing mix. However, e-commerce and marketing are areas that need further research to fully understand its mechanism and performance in the marketplace. The managers responsible to develop those strategies most of the times do not have the updated information of the real composition of their target segment. In this study, we will identify the factors that influence in the Mexican e-commerce buying decisions. A qualitative study was used with an e-mail sample of 593 students from a private university in the north part of Mexico. The results suggest that Mexican e-commerce buying decisions are influenced by the individual's mistrust in electronic commerce, brand loyalty, product demand, logistic issues, language skills, and demographic variables. The present research concludes with managerial recommendations.

Introduction

Nowadays, for developed countries, advances in information technologies are very common. In Mexico, electronic commerce has grown to be considered an important sector of the economy. This growth in the economy sector can be divided into two main areas. First, new businesses, aware of the benefits that information technologies offer, have implemented electronic commerce as part of their business unit strategic objectives since their beginning. Secondly, established businesses have started to implement electronic commerce as a way to add to their marketing mix. In this case, focus has been set on adapting traditional channels of distribution to their electronic commerce activities. In doing so, established businesses are unifying the efforts of the marketing mix to be congruent with the present business strategy. E-commerce and marketing are new areas for some organizations and these areas need further research to fully understand its mechanism and performance in the market. That is the way that the company will effectively face their competitors and fulfill a diversification in their chosen market. Although a synergy is what is required in order to have a strong and balanced marketing strategy, the managers responsible to develop those strategies most of the times do not have the updated information of the real composition of their target segment. A detail analysis of the target consumer and its buying behavior is important to fully co-penetrate business strategy with business performance.

It is in this line of reasoning that we present a typology of the Mexican electronic consumer (e-consumer) behavior. In doing so, we will identify the factors that influence the Mexican e-commerce buying decisions. A qualitative study was used with a sample of 593 students from a private university located in the north part of Mexico, divided in two different samples: sample one, those consumers whom have bought goods through the internet; sample two, consumers who have not bought on the internet. The results suggest that Mexican e-commerce buying decisions are influenced by the individual's mistrust in electronic commerce. Others factors that have an influence in the Mexican consumers' buying behavior are brand loyalty, product demand, logistic issues involved in the fulfillment of the e-commerce encounter and experience with the product. The demographic variables that have an impact in the variables mentioned above are sex, age, education, and second language (English) skills. The present research concludes with managerial recommendations about growth strategies that will influence the buying behavior of the consumer when using electronic commerce.

Conceptual Background

In the past decades, the business world has gone through some important changes regarding the way in which consumers do their shopping of products and services. These changes are due to the increasing use of Internet as a tool for buying and selling goods and services in the market. Internet has been defined as a global structure of information (Peterson, Balasubramanian, and Bronnenberg, 1997) or as a massive, global network (Hoffman, Novak, y Chatterjee, 2002), however all the definitions agreed to consider the Internet as an efficient medium for the access, organization, and communication of information between people and organizations. Extending this concept to the commercial transactions with electronic media and technology, we have reached to the e-commerce definition (Chircu y Kauffman, 2000).

E-commerce has various types of relationships: Business to business (B2B), consumer-to-consumer (C2C), consumer to business (C2B), and business to consumer (B2C) which is one of the most popular in the US. In contrast, in Mexico the main presence has been in the B2B transactions. Some estimates for electronic trade in Mexico pointed out 2 billion in 2003 of which only 600 million might be for consumer trade (Greenberg, 2000) in the present study we will focus only in B2C transactions.

Numerous investigations and theoretical conceptualizations are due to the strong popularity of the E-commerce worldwide, having the application to e-commerce strategies as one of the most researched areas. For example, Hoffman and Novak (1997) describe the e-commerce as a new marketing paradigm that can lead to a market in which cooperation would be more beneficial than competition, and to share information more fruitful than information control. Wind and Mahajan (1999) pointed out the importance of changing the marketing practices in this digital revolution, emphasizing on the agility and flexibility as key principles in the development of strategies.
Meanwhile, Peterson et al (1997) examined the Internet potential to reduce costs rather than generating profits. Evans and Wurster (1999) studied the competitive advantages.

Other line of research has been the study of inherent traits of e-commerce; Yadav and Varadarajan (2000) explore the user's role in the modifications of content and format in the actual environment. This is the way they defined interactivity. On the other hand, the intermediaries role has also been studied (Gosh, 1998; Chircu and Kauffman, 2000) and it has been though that cybermediaries might increase the market efficiency by creating scale and scope economies. In addition, the possible channel conflicts have been analyzed (Shaffer y Zettelmeyer, 1999).
Regarding consumers, new topics have been investigated. Like importance of the brand and trust on the Internet (Urban, Sultan y Qualls, 2000), price sensibility (Lynch y Ariely, 2000; Degeratu, Rangaswamy y Wu, 1999), buying process decision-making (Häubl y Trifts, 2000), and the factors that have impact on the shopping experience on the internet (Vellido, Lisboa y Meehan, 2000).

The buying process of a potential costumer is one the topics that cause great expectations among retailers, because their success and even survival depend on the knowledge of the market and the way their costumers react to different strategies. The results of the investigations cited above are of great importance for the US market, because is there where most of the studies have been conducted. The great amount of information about the Internet that has been produced has been very useful for store managers and businesspersons allowing them to design better-planned strategies since it vital information obtained from the US market. However, this information is not useful for businesspersons interested in the Mexican market, where the socio-economic situation and culture are quite different. In Mexico, the e-commerce is growing at a fast rate, but investigations on the Mexican market are scarce. Consequently, the decisions taken by executives in the Mexican market are merely intuitive or based in data coming from other markets. Therefore, the primary goal of this study is to increase the understanding of the Mexican e-consumer.

Internet in México

Study the development of the Internet in Mexico is not an easy task. There is a paucity of studies in the area and the data reported in them pointed out in several directions, this situation makes even harder the organizational decision making regarding e-commerce. Officially, the first organizations to be connected to the Internet were ITESM and UNAM in 1987. Universities were followed by other organizations like the government and businesses.
The number of Internet users reported in 2000 in Mexico was 2.6 million. The forecast of annual growth for the year 2000 was 37% (Select-IDC, 2001a). However, CETNET News (2000) published an estimate of 1.7 million for the same year, and a study of Net Value (Jones, 2000) limited the amount to 571,000 users for the same period. The

INEGI (National Institute of Statistics, Geography, and Informatics) reported data from 1995 to 2000, showing 2,712,000 users for the year 2000 (INEGI, 2000).

Without a doubt internet is growing in Mexico, even though it has not reached the level of other developed countries. For 2002, it was estimated that a 1.34% of the Mexican population was Internet users (Curry, James and Kenney, 2002). This is very low, comparing to the US or Japan. Anyhow, different forecast can be found about the Internet growth for the Mexican market. This is shown in Table 1.

TABLE 1: ESTIMATES OF INTERNET USERS (IN MILLIONS) IN MEXICO

Year	**Users (Millions)**	**Source**
2002	4.2	Curry, James, and Kenney, 2002
2003	26.0	Mindshare, 2000
2003	7.5	Curry, James, and Kenney, 2002
2004	9.2	Select-IDC, 2001[a]
2005	5.0	CNET News, 2000

According to data published by the INEGI (2000) organized in activity sectors in 1997, the area with the most rapid growth in personal computers connected to the Internet were business with a 55.67%, followed by households with a 17.75% , education with a 13.04% and the government with a 2.54%. Nevertheless, households and businesses have an annual growth index of 82% and 79% respectively. Data reported by INEGI is shown in the table 2. .

TABLE 2: INTERNET USERS BY SECTOR OF ACTIVITY 1995-2000 (THOUSANDS)

Sector	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**
Government	3	5	14	31	167	193
Households	10	29	141	297	478	1,006
Education	33	69	142	154	166	276
Business	48	84	299	740	1,010	1,177
Total	94	187	596	1,222	1,821	2,712

E-commerce in Mexico

Mexican e-commerce has been growing rapidly. In spite of several factors like limited infrastructure, high access costs, and low credit card penetration and a common misperception that Latin America countries are not ready for e-commerce, in 2000, Mexico was in the second position in retail e-commerce after Brazil and followed by Argentina. According to a report from e-Marketer, a research firm from New York, Latin America electronic commerce might represent five percent of the internet users worldwide by 2003 and Mexico could reach 107 billion in e-commerce trade (Greenberg, 2000). Several factors might help to support the growth of the B2C e-commerce in Mexico. First, before 2000, all contractual agreements in Mexico required a physical signature. In that year, Mexican government approved a new law where internet purchases orders are considered binding contracts, electronic transactions are required to comply with existing commerce and advertising standards, copies of the transactions must kept for 10 years, and electronic consumers data are kept confidential (Greenberg, 2000). Second, per-call phone charges and cable modem services, a proliferation of cyber cafes, large organizations, particularly universities, providing free access to their students, and prices decline in computers and components (Curry, Contreras, and Kenney, 2002). Some of the factors that still need attention are the high service costs, low phone line density, poor telephone service quality, and an inefficient public postal service (Curry, Contreras, and Kenney, 2002).

Mexican E-Consumer

Methodology

For the present research, a previous study was conducted among 100 students to determine the products that they usually get from the Internet. The products most bought were electronics and books, which the results are shown in table 3.

TABLE 3: PRODUCTS BOUGHT BY INTERNET

Product	Percentage
Electronics	16
Books	16
Clothing	14
CD’s /DVD	13
Tickets	7
Software/Games	5
Collectibles	5
Air tickets	5
Sport Goods	4
Reservations	4
Groceries	4
Gifts	3
Flowers	2
Magazines	1
Watches	1

Because of the nature of the sample, students (undergraduate and graduate), books were chosen for the study. An e-mail list of students from a private college in Northeastern Mexico was obtained. An invitation was sent to the sample with a link that took them to the questionnaire. 593 responses were received.

Results

The results shown 390 cases in which consumers did not buy in the Internet their books and they bought them at local libraries instead. There were 191 consumers who reported that they did buy on the Internet, and 124 bought at an American website. (Amazon, Barnes & Noble, Publisher web sites), 67 bought them in Mexican websites (Sanborns, Submarino, Gandhi, Delfos, DeCompras, Book Shop, and Publisher`s web sites), and 12 cases of no response.

Traditional Consumers

The amount of participants that reported a negative response towards the Internet shopping was of 390.The reasons given to explain why they choose to get them in morter and brick bookstores are shown in table 4.

TABLE 4. REASONS WHY PARTICIPANTS DO NOT BUY IN THE INTERNET

Lack of Trust	21.2 %
Local bookstore preference	19.0 %
Book available in local bookstore.	17.9 %
No Credit Card	14.2%
Enjoyment in the book display	5.6 %
Immediate delivery	4.6 %
Cost	4.0 %
Do not buy books at all	3.8 %
Not yet	3.4 %
Not interested	2.1 %
Dislike the experience	1.6 %
Previous bad experience and bad service	1.6 %

Electronic Consumers

Of the consumers that did make an electronic shopping, 65% of them shopped in Amazon.com, and the 35% in other on-line bookstores (Barnes & Noble, Sanborns, Submarino, Gandhi y otras). The reasons they expressed for their Internet preference were: The book was available online only; the company's reputation, topics, author, delivery time, service, price, positive experience, and the easy process are among the most important factors. Participants were asked to distribute 100 points to grade the importance of each factor in terms of buying decision. Results are shown in table 5.

TABLE 5: IMPORTANCE OF THE FACTORS IN THE DECISION PROCESS.

Factors in the decision process	**Weight (means)**
Book was available online only	25.35
Easy process	15.99
Reputation	15.32
Delivery time	10.69
Service	10.06
Topics	8.81
Positive past experience	8.79
Price	7.62
Author	3.94
Others	1.61

When the participants were questioned about why the like to buy on an electronic site their main responses were based on convenience, they said it is easy, save time, or they can buy at any time. The results are shown in Table 6.

In respect to the demographic variables of gender, age, education, income, and language skills, the results were the following: It was found that gender, age, education, and language skills (English) are related with the e-shopping behavior, while income does not. These aspects will be described below briefly.

TABLE 6: REASONS WHY I LIKE TO BUY ELECTRONICALLY

I like to shop electronically because:	**Percentage (More than one answer)**
It is Simple	71.8
Save time	67.7
I can buy any time	67.7
It is convenient	62.1
Compare product and prices	54.8
Immediate Information about the products	53.2
Variety	50.0
Additional services	18.5

Gender

The 43.3% of men stated they bought books through the Internet, while just the 22.9% of women did.

Age

The 60.9% of the participants in the age range from 30 to 34 do buy through the Internet. This percentage is significantly larger than the rest of the categories, 17% in the range from 18 to 24, and 39% in ages 25 to 29. The difference among the percentages for the rest of the categories was not significant.

Education

It was found that with higher education level, the greater the likelihood to buy through the Internet. Among the undergraduate students, only 10% bought electronically, while the participants with a college degree percentage were of 40%, and the graduate students reported 43%.

English
Similar results were found with second language skills (English). The greater the English level, the higher probability of buying through the Internet. Those who mentioned to have a 41 to 60% of English, only the 19.3% bought books electronically. From the 61-80% of English speakers segment, the percentage was 27.1% and the ones who reported an 81-90% of language skills, the percentage was high 35.1%, and for who had complete domain over English as a second language (91-100%) the percentage was even higher 44.3%.

Discussion

The main reason for not buying books over the net is related with the lack of trust to the website. This explains mainly as the unwillingness to provide personal information like credit card numbers through this medium and the misuse that could be given to that information. Other related reason for this lack of trust is the perceived risk that, once a product is paid, it will not be delivered. In general, the Internet was not considered a safe medium for commercial transactions.

The personal attention and advices from the salespersons are the key elements that make them prefer traditional stores. Another important factor is that large amounts of Mexican population do not have credit card access. Other factors mentioned were related to the logistics and costs of the goods. It is interesting noticing that only a small percentage of the respondents reported bad past experiences during internet shopping.

Next, we will discuss some strategies that might be considered to overcome these barriers to the development of the e-commerce and how could they be applied to Mexico.

Strategies

Trust
As the results show, trust is one of the elements that have an impact on the Mexican buying behavior. In order to provide the user with an environment that could provide the basis for trust building and creating a relationship with the Mexican consumer, it is important that we take into account the types of consumers that are acquiring products through the electronic market. Are Mexican consumers innovators, early adopters, late adopters lagging behind? Are the Mexican consumers choosing the e-markets because of an impulse, emergency, commodity, convenience, or luxury buy? Although the type of consumer is important, trust is an element that has to be part of both sides, the company that provides its products/services on the electronic market and the Mexican consumer.

The electronic commerce is one opportunity to promote exchange and to build relationships, mainly because there is an increasing rate of technological change and diffusion, the substantial changes in information technology result in an information-rich, computation rich, and communication rich organizational environment (Bettis and Hitt, 1995). In addition, there is an increase in knowledge intensity and the emergence of positive feedback.

According to Gurbaxani and Whang (1991) the Internet model is based on the agency and transaction cost theory. The former views the firm as a nexus of contracts among self-interested individuals and later assumes that the firm exists because various transactions markets costs are minimized when the firm bypasses the market and coordinates production itself. In other words, the internet model is one that can promote the growth of trust in the users due to the nature of the transactions and the participants involved. Trust has the potential to develop with the increase and repeated use of the media for consumption purposes. It is hardly unlikely that trust will have an impact on sporadic consumers.

On the other hand, trust building and maintenance must be the objective of the company. According to Morgan and Hunt (1994), relationship marketing is establishing, developing, and maintaining successful relational exchanges. This relational exchange involves commitment, trust, and satisfaction. For companies that offer their products on the Internet, it is important to know and control these elements in order to have a better performance, measured as sales. Cultural barriers will always exist, but it is in the best interest of the companies providing products on the electronic markets to assure that the information that is about to receive from the consumer will be used only on behalf of the consumer (e.g. credit card information, buying behavior, comments and feedback). If the companies that are into e-commerce realized which elements are embedded in the sales transaction, they could view this process as a relationship-marketing paradigm, and develop strategies to that specific market.

Product

Many factors will influence a consumer's decision to shop electronically versus in-store. Alba et al. (1997) found that the growth in the use of e-commerce depends on a vast selection of products, product screening, product reliability and product comparison available to the Mexican consumers. In our research, the products that were thought of being bought using e-commerce had the characteristic to be part of the shopping goods products classification. Several marketing researchers as Kotler, Lamb et al. and Pride and Ferrel have researched this classification.

Some of the elements of this classification refer to the consumer in an effort to select and purchase the product, compares products on such bases as suitability, quality, price, and style. For this product category, it is expected that consumers will prefer retailers that freely provide such information and make cross shopping easy; therefore, isolationist vendors could be bypassed in the search process. In the Mexican context, the importance of search engines that are able to pull the variety of products into the consumer's attentions is vital. Language barriers must be minimized in order for the consumer to get a vast variety of products that will satisfy their needs. When being exposed to a great variety of products, the consumer also learns about them, and gets involved in the process, lending to increased use and potential electronic consumption. By providing more information to consumers with minimal search cost, manufacturers and retailers with differentiated offerings will have a greater opportunity to educate consumers about the unique benefits they offer, and consumers will find it easier to access and compare the offerings of firms competing on price.

Since there is not really a specific type of Mexican consumer in the electronic market, such inherent consumer heterogeneity suggests that any retail format can dominate all segments of consumers. Instead, product specificity will determine which products are more likely to be traded and consumed using an electronic format.

E-commerce Service Encounter

In the electronic markets, the Mexican consumer is looking for an alternative to satisfy his/her needs. Thus, cooperation from both the consumer and the provider requires an active participation in the relationship to achieve mutual benefits. The trust fostered in dedication-based relationship maintenance is conducive to coordinated, cooperative behavior (Pruitt, 1981). Furthermore, Berry and Bendapudi (2003) concluded that relationship maintenance is important in keeping customers. The possibility exists that customers might lessen its interest for the company or product, but still will be less likely to leave and search for another. In the Mexican context, emphasis should be made on developing this interaction between consumer-product/company. Relationship enhancement the customer makes investments in the relationship; this may depend upon the basis on which they maintain their relationships with service providers.

Another important element that should be taking into account is what the switching level is for the Mexican e-commerce consumer. Keaveney (1995) concluded that consumer-switching behavior involves the price of the product in question, inconveniencies with the product, failures with the core service, failure with the service encounter and failure in responses from the employees, competitive issues, ethical problems, and involuntary factors. Her major premise lays in the fact that companies must deal with behaviors and actions and with the willingness to be loyal. In regards to the e-commerce arena, technology plays an important role in enhancing the service encounter with the consumer. Nevertheless, if these elements are incorporated in the encounter and are clearly appreciated by the Mexican consumer, the positive result will have the possibility to create a relationship with the Mexican consumer.

Customer experience is also a key factor in the service encounter. As we mentioned earlier, in this present research, the product into considerations were mainly those that were classified as shopping goods. It is inherit in this classification that the consumer has previous experience with them and is in the process of make a selection through comparison. Thus, previous experience by the Mexican consumer with the product will play an important factor in the selection of the media to buy. If the Mexican consumer incorporates the previous experience with the product in the e-commerce setting, the degree of experience, the result of that experience and the overall satisfaction will play a key role in selecting e-commerce as a media to buy. Thus, these elements must be taken into consideration.

Conclusion and Further Research

The Mexican consumer in particular is important to take into account as a retrospective look at how marketing can be a potential value in enhancing the process of creating new marketing knowledge that could benefit companies in their strategic process for their electronic markets. By understanding the barriers and blocks to the process of electronic consumption, marketers should be able to learn something about how to make it work more effectively in regional markets. Support should be provided for basic technical and non-technical reviews of new concepts, findings, and techniques in the dynamics of electronic markets so the Mexican consumer could follow the trends and adapt those to the products that have the potential to make a match. The conclusion here is that we hope for greater sensitivity to concerns for the state of the Mexican consumer behavior towards the electronic markets.

Opportunities for further research are in the lines that Alba et al (1997) mention of what would be the fundamental changes that can occur in information processing of the Mexican's consumer choices and behavior, how do content and presentation of the product information affect Mexican's consumers' willingness to make choices without directly experiencing the product and ease on the trust factor, and how will Mexican consumers react to the collection of detailed information about their needs and purchase behavior? In addition, in the lines on product and e-commerce, we will find a new research area that investigates the various elements of product and its categories. In the product development area, the several research areas will be whether the consumer (or buyer in B2B markets) has knowledge of the characteristics of the product and what the consumer behavior approaches towards it are. What are the kinds of products that are more feasible to be exchanged or transacted through the e-markets? What is the pattern of buying behavior of those products and what are the distribution issues of them.

In the brand area, the research will be toward what is the degree of brand recognition. Is it possible to create and develop a brand that applies to the global and unidentified segment of the e-market participants? What are the ways in which the firm can capitalize on the bran equity that will be formed? In the package area, what is the relevance of package in e-markets? What is the impact on R&D in package development for e-market products? This research can benefit from the construct of organizational memory, since one of the benefits of e-markets is the interactivity and flow of information between users. The challenges that presents this construct is the way the firms will manage such amount of information and what will be the financial repercussions of them in the firm's performance.

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Section 9
Corporate Governance & Institutional Framework

Exploring the Impact of Corporate Governance System on the International Strategies of SMEs

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Abstract

Several theoretical and empirical works have demonstrated that corporate entrepreneurship is fundamental to achieve sustainable competitive advantage in the firms facing turbulent environments. One of the factors that can influence corporate entrepreneurship is the corporate governance system. The relationship between corporate governance and corporate entrepreneurship has particular characteristics in SMEs, where the association among governance structure, strategic leaders and firm performance is more pronounced [Daily et al., 2002]. In this paper we attempt to explore the relationship between CG and CE in SMEs using international venturing as dependent variables. Internalisation of SMEs can in fact be considered as a CE activity. Our main hypotheses are that structure of ownership and governance bodies can influence the internationalisation strategies, and that environmental dynamism acts as a moderating variable of these relationships.

Corporate Governance and Corporate Entrepreneurship

Corporate entrepreneurship [CE] is defined in the seminal work of Miller [1983] as the capacity of a firm to engage in product-market innovation, to undertake risky ventures and to come up with proactive strategies. Various authors have subsequently focused their attention on the ways of creating new businesses within established firms to build up long-term competitive advantages. The study of CE has thus become an integral part of the strategic management literature. Several researchers have analysed forms, antecedents, and effects of CE activities; some authors have emphasized the product/process and technological dimensions of these activities [Covin and Slevin, 1991; Burgelman, 1991], while others have highlighted aspects such as entry in new markets [Lumpkin and Dess, 1989] and strategic change [Guth and Ginsberg, 1990, Dess, Lumpkin and McGee, 1999].

Empirical evidence suggests that corporate entrepreneurship can improve organizational growth and profitability [Zahra, 1991, 1993; Zahra & Covin, 1995]. Moreover, it has been argued that entrepreneurship at the firm level can enrich a company's performance by fostering organizational learning and creating new knowledge that becomes a foundation for building new competencies or revitalizing existing ones. Learning in CE activities entails the acquisition of new technical, social, and organizational skills [Zahra, 1999].

Previous research has showed that the determinants of CE are both external and internal; while external factors are related to environmental traits, such as competitive dynamics and institutional context; internal factors refer to the “entrepreneurial posture” of the organization [Covin and Slevin, 1991]. The literature has widely recognized that it is difficult to create a fit between entrepreneurial activities, characterized by ambiguity, risk taking propensity and innovation, and organizational structure, created to ensure control and efficiency. Various authors tried to define the managerial, structural and cognitive variables that can stimulate entrepreneurship within an organization [see for example Jelinek and Litterer, 1999; Hjort and Johanisson, 1994]

One important variable that can influence the entrepreneurial posture of a firm is the corporate governance system [Zahra, 1996]. We define corporate governance system as the system through which firms are directed, controlled and made accountable towards their stakeholders [Cadbury, 1994; OECD, 1999]. The concepts of control and accountability refer to the functions of monitoring and evaluation of the managerial behaviour, to ensure that top executives pursue the interests of the main stakeholders; the notion of direction includes the functions of strategic goal setting and definition of the long term objectives of the firm. The influence of corporate governance on corporate entrepreneurship and, in particular, on strategic change, has been mainly analysed studying the role of the board of directors [Hill and Snell, 1991; Baysinger et al., 1991, Goodstein et al., 1994; Zahra, 1996; Stiles, 2001; Golden and Zajac, 2001]. These researches are grounded on various theoretical perspectives; the main arguments come from agency theory, resource dependency theory and upper echelons theory. According to agency theory, board enhances corporate entrepreneurship ensuring that firm resources are allocated efficiently to areas necessary to long term advantage and superior performance [Zahra and Pearce, 1989]. Resource Dependency Theory suggests that the survival and success of the firm depend upon the ability to build up networks of relationships and obtain critical resources from the external environment [Pfeffer and Salancik, 1978]; thus, boards can influence entrepreneurship by including people that brings innovative competences and new strategic insights to the organization [George et al., 2001]. Upper echelons theory studies boards as the main decision making groups, whose role is shaping the firm's strategy [Hambrick and Mason, 1984; Hambrick and Finkelstein, 1996; Forbes and Milliken, 1999]. A basic assumption of the upper echelons model is that demographic characteristics are systematically related to the psychological, cultural and cognitive elements of the firm leaders.

Research using this theoretical framework has linked the demographic characteristics and/or the demographic diversity of the "managerial elites" to a variety of organisational outcomes including: financial performance [Keck, 1991; Hambrick and D'Aveni, 1992; Michel and Hambrick, 1992;], strategy [Finkelstein and Hambrick, 1990; Michel and Hambrick, 1992; Pegels, Song and Jang, 2000], strategic change [Grimm and Smith, 1992; Wiersema and Bantel, 1992] and organisational innovation [Bantel and Jackson, 1989; Smith et al. 1993]

The relationship between governance and entrepreneurship shows particular features in small and medium enterprises, where exists a high degree of overlap between ownership and management functions. In addiction, small firms are in the vast majority family firms, where the ownership, governance and management functions are held by one or more families, linked one another by parental ties or strong alliances [Corbett, 1995]

To understand and explain the influence of CG on CE in small and medium enterprises, theoretical suggestions need to be adjusted to fit the specific characteristics of these firms. For example, agency problems are often strongly reduced by family relationships that act as a source of trust and commitment [Mc Conaughy, Mc Conaughy et al., 2001] and work as a powerful mean to align the interests of stakeholders, providing effective allocation of resources to reach long term objectives.

The arguments of Resource Dependence Theory can be applied to the presence of non family members in the board; these outside directors can promote innovations in the entrepreneurial culture and help overcoming the resistances to change that often characterize family firms [Salvato, 1999; Johanisson, Huse, 2000, Gabrielsson et al., 2002].

Moreover, upper echelons theory is particularly suitable to analyse the strategic role of the board in SMEs, because board members are often involved in the daily management and have direct and frequent contacts with the other executives, thus the role of the governing body in shaping and evaluating strategy is reinforced [Daily et al., 2002].

Recent empirical work focusing on SMEs has adopted these perspectives, analysing the impact of the governance system [in terms of both ownership structure and board functions] on entrepreneurial posture and behaviour of firms, measured through proactiveness, risk taking propensity, product innovation [Gabrielsson, 2002; Salvato, Marchisio, Corbetta, 2002; Salvato, 2000; Zahra, Neubaum, Huse, 2000] and specific innovative activities in organization and strategies [Nordqvist, Brunnige, 2001; Compagno, Pittino, 2001, Corbetta, Gnan, Montemerlo, 2001]. These studies have confirmed the importance of CE in building the competitive advantage, especially within small firms facing fast changing and dynamic environments.

Internationalisation as CE activity

Despite the lack of attention by the international business theories, the internationalisation of small firms is an important phenomenon in Europe. It has been estimated that over 40% of European small and medium firms work with foreign partners[i]. Small and medium enterprises adopt a huge variety of international strategies, ranging from export processes to partnerships, joint ventures and direct investments. There are several reasons why small firms should do international business; some of them are:

- access to new markets and social networks
- access to new technologies and human skills
- attainment of a stronger position towards customers and/or suppliers
- access to production capacity and financial capital
- enrichment of the entrepreneurial culture

The empirical literature has classified the factors that lead to internationalisation of SMEs in three groups [Donckels, 2001:

Personal traits of the entrepreneur[s]: general attitude towards collaboration, openness towards the international scene, specific knowledge and experience; willingness to delegate.

Organizational characteristics*:* variety of strategic options and product-market combinations; availability of financial resources; ownership structure; change-oriented corporate culture.

Environmental and institutional factors: favourable network position [in particular, complementarily with large enterprises within firm networks]; presence of supportive infrastructures such as Chambers of Commerce, Entrepreneurial Associations, regional development agencies; active role of political and administrative authorities at various hierarchical levels [local, regional, national, European].

The first and second group of determinants, i.e. the “internal factors”, are strongly linked with the entrepreneurial posture of the firm; Internationalisation strategies can be defined as corporate entrepreneurship activities because they require risk taking behaviour with regard to investment decisions and strategic actions, proactive action towards the competitors, product and market innovation. These are some of the elements included by Covin and Slevin [1991] in their definition of entrepreneurial posture.

Moreover, internationalisation is often the result of a high openness to change by the firm leadership. It is well known that small and medium firms often demonstrate a resistance to change that limits their competitiveness: internationalisation requires a cultural change by the leadership and implies a learning process from the external environment that enrich the entrepreneurial and managerial culture and know how and creates new knowledge [Minguzzi and Passaro, 1999]. The learning processes in the internationalisation strategies are evident among the small firms that adopt the so called “new forms of internationalisation”, such as partnerships, non equity agreements, joint ventures, etc.

As we pointed out in the previous paragraph, this knowledge creating and competence enhancing effect is one of the main implications of the corporate entrepreneurship activities [Zahra, 1999]. Zahra, Neubaum and Huse [2000] have also employed the international venturing activity as one of the indices defining the overall entrepreneurial activities in medium sized established firms.

The link between internationalisation and CE is also confirmed by empirical data at the macro level. For example, a broad survey conducted among the Italian SMEs showed that almost all the firms that adopt internationalisation strategies have recently introduced process and/or product innovations[ii].

Corporate Governance and Internationalisation

The studies that analyse the internal determinants of internationalisation often adopt a resource based view [see for example Westhead, Wright, Ucbasaran, 2001; Habberson and Williams, 1999]. The same perspective should be assumed if we want to analyse the relationship between corporate governance and internationalisation.

In fact, the corporate governance system is at the same time a set of resources and a way to allocate the resources themselves. It is a set of resources because in the governance bodies we can find subjects that provide financial capital, in terms of equity and debt, and human capital, in terms of entrepreneurship, technical and managerial competences, decisional ability and network relations. On the other hand the governance system may also be intended as a way to organize resources. Using the language of the resource based view; Corporate Governance can be therefore viewed as a "Dynamic Capability" [Teece, Pisano, Shuen, 1997], because it represents the principal lever to move and combine resources and competences inside the firm, to pursue long term objectives.

In our perspective, we assume that the corporate governance system influences the “quality” of the internationalisation process of the small firm, especially in terms of adoption of advanced forms of internationalisation such as: partnerships, joint ventures, foreign direct investments.

The first governance variable that can affect the internationalisation strategy is the ownership structure. Empirical research suggests that the evolution of the internationalisation strategy in SMEs is positively related to the number of owners: the opening of the ownership structure provides major financial resources and increases the risk propensity. This effect however is less pronounced in the smallest firms [Becchetti and Gonzales, 2001].

It has been also demonstrated that the presence of family relationships between owners has a positive effect in controlling managerial entrenchment and agency costs, promoting long term commitment and an efficient allocation of resources within the firm [Bekaert and Harvey, 2000; Stulz, 1999; Mc Conaughy, 2001]. This is a factor that can stimulate investments in internationalisation. On the other hand, concentration of the ownership exclusively in the hands of the family can lead to risk aversion and discourage innovative strategies; thus, the optimal ownership configuration should have, in addition to the controlling family, other non-family investors. For example for the machine tool sector, Visintin [2001] shows that opening the ownership to non family members increases the likelihood to innovate, but this happens up to a certain level of opening.

On the basis of this argument we can formulate the following:

Hypothesis 1: The presence of non family owners in addition to the controlling family in small and medium enterprises positively influences the adoption of advanced forms of internationalisation

International strategy can also be influenced by the structure and roles of the main governance bodies. We refer to the “governance bodies” and not simply to the Board of Directors because in SMEs the Board is often composed by people that are directly involved in the daily management of the firm, thus the members of the board and the other top executives [where present] should be considered as parts of the same strategic decision-making structure. Moreover, the sole board composition in SMEs does not provide us with useful information about the “strategic direction functions”, because in these firms boards are often constituted only to accomplish legal requirements.

In previous empirical studies it has been observed that the features of strategic decision making groups of the small and medium enterprises can impede internationalisation [Gallo et al., 2002] because these groups are in many cases characterized by strong cultural homogeneity and low receptivity to change. We may argue that groups with opposite characteristics are more inclined to adopt international strategies. According to Upper Echelons Theory, creativity and receptivity to change are dependant on the homogeneity/heterogeneity in the demographic traits of the strategic decision making group. Homogeneity is “an aggregate level index of interpersonal similarity along one, or several, dimensions” [Murray, 1989 pg. 126]. The members of a homogenous team are usually of a similar age, they have the same organizational tenure, and they have similar career backgrounds. A homogenous team is, above all, able to achieve a consensus on decisions, since the members have shared values and culture [Priem, 1990; Pegels, Song and Yang, 2000]. In family firms, the central figure of the entrepreneur generates a strongly homogenous firm culture. Homogenous team presents continuity in the decision-making process, language and values integration, easy communication and problem-solving.

Nevertheless, homogenous teams can also determine a high level of conformism, a feeling of invincibility, a strong groupthink effect and a lack of “information-sharing” [Grandori, 1999].

Heterogeneous teams have the opposite traits. The cognitive base of a heterogeneous team has a fundamental diversity. The team tends to use information from a wide range of sources and employs various methods and perspectives to interpret the reality. A diversity of values in the group results in a high level of complexity and a low level of consensus. Consequently, there is an increase in "the search of information, the perception that change is feasible and the momentum for change" [Dutton and Duncan, 1987].

In the strategic decision making groups of SMEs, the active presence of non family members can be an important factor of heterogeneity as it enhances the learning processes, the willingness to take risks and the propensity towards innovation, that are necessary to pursue advanced international strategies. Moreover, the presence of non family members is also important in a Resource dependency perspective, because it provides useful links to the external environment.

We can synthesize the previous arguments in the following:

Hypothesis 2: The presence of non family members in the strategic decision making groups of SMEs positively influences the adoption of advanced forms of internationalisation**.**

Studies assuming a contingency perspective introduce the environmental dynamism as a moderating variable of the relationship between the characteristics of the strategic decision making groups and the adoption of effective strategies [Fig.1] [Priem, 1990; Knight et al., 1999]. Perfect homogeneity-consensus situations or perfect heterogeneity-disagreement situations are not desirable in any kind of environment, but these researches show how more homogeneous teams, where there is a high level of consensus during the decision process tend to adopt effective strategies in stable environments, whereas groups with higher heterogeneity are more suitable to operate in turbulent and discontinuous environments [Hambrick and Mason, 1984; Pegels, Song and Yang, 2000].We have previously pointed out that CE activities and, therefore, international strategies depend upon internal and external conditions. We can assume an external factor, such as the degree of environmental turbulence, as a moderator of the relationship between structure of the strategic decision making groups of SMEs and adoption of advanced internationalization strategies.

Hypothesis 3: The positive relationship between heterogeneity in strategic decision making groups and adoption of advanced international strategies is more pronounced in turbulent and dynamic environments.

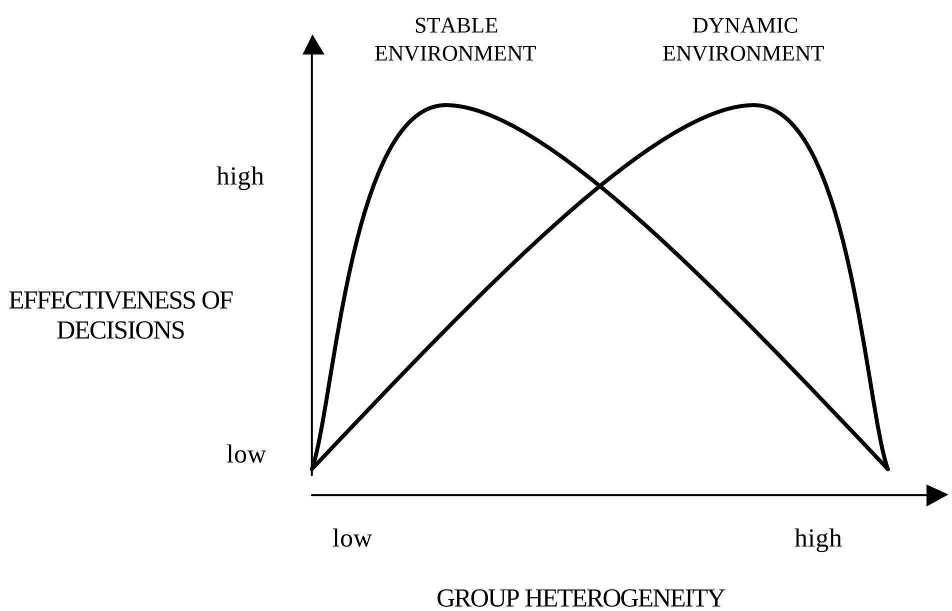

FIG 1 THE ROLE OF ENVIRONMENTAL DYNAMISM AS A MODERATOR OF THE GROUP HETEROGENEITY - DECISION EFFECTIVENESS RELATIONSHIP. SOURCE: ADAPTED FROM PRIEM (1990)

Sample and Methods

To test the hypotheses, we have analyzed data from a survey that we are carrying out on a sample of 300 Italian small and medium enterprises belonging to three different sectors: furniture, machine tools and electronics. The sample was extracted from the Mediocredito Centrale Database[iii]. The general aim of the survey, that has still to be completed, is to explore the evolutionary paths of Italian small and medium enterprises; data are collected through phone interviews, based on a structured questionnaire, with the president or the CEO of the firm. So far we have completed 152 interviews.

For the purposes of the present research we have analyzed only the data concerning the governance structure and to the internationalization processes, choosing family firms only. This has restricted the sample to 116 enterprises.

We have chosen three sectors that present clear differences in terms of competitive and technological characteristics. Following the Patel and Pavitt [1994] classification, wood-furniture, machine tools and electronics can be respectively defined as traditional, specialized and high tech sectors. We can assume that environmental turbulence increases as we move from traditional to high tech sectors.

We have studied the processes of internationalisation observing the various forms through which the firm operates in the foreign markets: indirect export, direct export, partnerships [technical-production related or commercial], joint ventures, foreign direct investments. These typologies are characterized by different levels of risk and financial-strategic involvement by the enterprise.

The corporate governance system has been analysed through the following variables:

1) ownership structure
2) board composition
3) actual distribution of the strategic decision making functions among board members and other top executives

To simplify, we have considered two types of ownership structure: 1) *complete family ownership*, where the ownership structure is composed only by family members; 2) *open family ownership*, when non family members [persons, firms, financial institutions] hold shares of the company.

To define the strategic decision making groups of the firms we have jointly analysed variables two and three, because the simple information about the structure of the formal bodies often tells us nothing on how the governance functions are actually allocated [Pettigrew, 1992]. Variable three was constructed by asking who were the responsible of the main strategic decisions within the firm. We have found three kinds of strategic decision making groups:

Closed family group*:* the board of directors is composed exclusively by family members, who are at the same time responsible for the main governance decisions. In some cases in the board we can find non-family members representing minority ownership stakes. These persons, however, don't exert any influence on the long-term strategy of the firm, as they play only a formal role.

Enlarged family group*:* the family members sitting in the Board are the ones that take the strategic decisions but the decisional process is supported by the key non-family managers, or by outside directors that are involved for information and/or consulting purposes.

Open group*:* the strategic decision making group is composed by family and non-family members, each with the same degree of power and responsibility. The outside directors sitting in the board have an active role in setting the future objectives of the firm.

We have studied the relationship between the governance system and the processes of internationalisation. We have then performed a cross-sectorial analysis to explore the moderating role of the environment.

Significance of the results has been tested through the chi-square method.

Results

Governance system

The empirical analysis has been carried out on a sample of 116 Italian family SMEs belonging to three sectors: wood-furniture [39 firms], machine tools [39 firms], and electronics [38 firms]. All the firms operate on the final market. With regard to the ownership structure, 65% of the firms have a complete family ownership. In the remaining cases we find other owners with minority shares. The higher proportion of open ownership structures has been observed in the electronics sector [46.5%]. On the contrary, in the wood-furniture sector, 85% of the firms have a complete family control. In the machine tools sector, 44% of the firms present an open ownership.

The typology of non family owners is almost the same in the three sectors: persons [50%], national companies [25%], foreign companies [15%], banks [10%] and institutional investors [4%]The majority of the companies has a board of directors [63%]; in the other cases we find the figure of the "sole administrator" ["amministratore unico"]. In the electronic sector the majority of firms has a Board of Directors that includes non-family members [61% of the firms]; again, we observe the opposite situation in the wood-furniture sector, where 58% of the firms has a board with family members only. In the machine tools sector 51% of the boards include non-family directors. We observe the presence of outside directors in 10% of the firms, with no relevant sectorial differences.

The strategic decision-making groups are in 42% of the cases closed family groups. Up to 26 % of firms have an enlarged family group, whereas in 32% of the firms, governance decisions are taken by open groups.

It is interesting to observe that firm size is not related to the adoption of specific governance structures. For example, closed family groups are equally distributed among all the size intervals.

Internationalisation processes

In our sample, on average, 44% of firm turnover comes from sales on international markets. In the machine tools sector this percentage is 50.3%, in the electronic sector is 41%, in the wood furniture sector is 40.2%.

As shown in table 1, the most widespread "structured form" of internationalisation is the technical-production partnership, relevant in all sectors. Joint Ventures and Foreign Direct Investments assume significant values particularly in the electronic and machine tools sectors

TABLE 1: FORMS OF INTERNATIONALISATION IN THE ENTERPRISES OF THE SAMPLE

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Forms of internationalisation	Electronics	Wood-Furniture	Machine Tools	All sectors
% Export	46	54	38	45
% Technical-production Partnerships	41.8	38.2	35.9	38.7
% Franchising agreements	1.1	5.1	-	1.7
% Consortia	4.6	2.9	2.6	3.4
% Supply partnerships	16.3	8.8	12.8	13
%Joint Ventures	13.9	5.9	10.3	10.3
%Foreign Direct Investments	11.6	11	15.4	12.7

We have observed that direct investments, in the majority of cases, have market seeking and labour seeking purposes. Only in the electronic sector we can see source seeking direct investments, i.e. investments aimed to obtain from the international environment critical resources such as capital, technologies, know how.

The dimension of the firm seems not to have influence on the adoption of advanced forms of internationalisation, except for the foreign direct investments, usually made by the bigger firms [more than 150 employees].

Ownership structure and internationalisation processes

Using the univariate analysis, we have found no support to our first hypothesis. The opening of the ownership structure to non-family members seems not to be related to the adoption of structured forms of internationalisation.

TABLE 2 RELATIONSHIPS BETWEEN OWNERSHIP STRUCTURE AND ADOPTION OF ADVANCED FORMS OF INTERNATIONALISATION. CHI SQUARE TEST SIGNIFICANT AT THE 0.01 LEVEL.

Ownership structure	Indirect export	indirect export	Tec.-Prod.-Supply Partnerships	Joint Ventures	FDI
%Complete familyownership	59	65	57	67	0
%Open family ownership	41	35	43	33	0

The chi square test for independence of the data reported in table 2 supports the opposite statement, i.e., the exclusive presence of the family in the ownership does not increase the risk aversion of the firm leadership; it seems, on the contrary, to enhance the entrepreneurial posture of the enterprise. No significant differences have been observed between sectors. This finding is consistent with previous results, indicating that in smallest firms the concentration of ownership in the hands of family is not negatively related to the adoption of internationalisation strategies [Bechetti and Gonzales, 2001].

The presence of non family owners, especially as long as they are not directly involved in the management of the firm, could hinder the adoption of entrepreneurial behaviours. The exception, again, comes from the foreign direct investments, that seem to be associated to open family ownership, but it is probably only a dimension-related effect.

Strategic decision making groups and internationalisation strategies

The analysis of data concerning all sectors [Tab.3] indicates that the presence of the enlarged and open groups is significantly lower among the enterprises that adopt the less advanced form of internationalisation, i.e. the indirect export. Among the firms that pursue advanced international strategies the percentage of the enlarged and open groups is significantly higher. This finding seems to indicate that the cultural heterogeneity and the new strategic insights brought by the non family members can influence the adoption of entrepreneurial and proactive strategies on the international markets. This seems to be true in particular when the firm is directed by an open group.

TAB. 3 RELATIONSHIP BETWEEN STRATEGIC DECISION MAKING GROUPS AND ADOPTION OF ADVANCED FORMS OF INTERNATIONALIZATION
* SIGNIFICANCE AT THE 0.1 LEVEL; ** SIGNIFICANCE AT THE 0.05 LEVEL; *** SIGNIFICANCE AT THE 0.01 LEVEL

	Indirect Export	Direct Export	Supply Partnersh ips	Technical Partnerships	Joint Ventures	FDI
%Closed family group	44	30	37	27	30	15
%Enlarged family group	30	35	30	22	25	7
%Open group	26	35	33	50	45	78
p-values	0.030635**	0.363254	0.599865	0.001162***	0.037332**	0.000064***

Interesting suggestions come from the comparison between sectors [Tab. 4].In the electronic sector the percentage of open strategic decision making groups is significantly higher among the firms engaging in technical-production partnerships, joint ventures and foreign direct investments, whereas the firms with the enlarged groups seem to have the same strategic posture as the closed family firms. The same trend is observable in the furniture and machine tools sector with reference to joint ventures and foreign direct investments.

We could say that an effective cultural change in the firm leadership occurs only when non family members are actively involved in the decisional processes and their competences are actually applied. The presence of non-family actors [including outside directors] that provide technical-specialistic information and play a consulting role seems not to have significant impact on the evolution of the strategic insights of the small and medium firms.

TAB. 4 RELATIONSHIP BETWEEN STRATEGIC DECISION MAKING GROUPS AND ADOPTION OF ADVANCED FORMS OF INTERNATIONALISATION: COMPARISON BETWEEN SECTORS * SIGNIFICANCE AT THE 0,1 LEVEL; ** SIGNIFICANCE AT THE 0,05 LEVEL; *** SIGNIFICANCE AT THE 0,01 LEVEL

	Indirect Export	Direct Export	Supply Partnerships	ec.-Prod. Partnerships	Joint Ventures	FDI
WOOD-FURNITURE						
% Closed family group	67	40	60	54	35	30
% Enlarged family group	25	50	10	10	15	15
% Open group	8	10	30	36	50	55
p-values	0.001873***	0.000443***	0.215681	0.029001**	0.051396*	0.000031***
MACHINE TOOLS						
% Closed family group	33.3	17	25	15	40	33

% Enlarged family group	33.3	33	50	31	10	12
% Open group	33.3	50	25	54	50	55
p-values	0.015443**	0.035648**	0.230832	0.054749*	0.078454*	0.000092***
ELECTRONICS						
% Closed family group	27	33	43	16.5	17	0
% Enlarged family group	27	23	14	16.5	17	20
% Open group	46	44	43	67	66	80
p-values	0.000001***	0.0482**	0.411568	0.029001**	0.032954**	0.000074***

Table 5 shows the direct comparison among sectors of the relationships between governance groups and advanced forms of internationalization. P values show that relationships are significantly different.

Hypothesis three seems to be supported observing the data, because the relationship between opening of the governance group and adoption of advanced forms of internationalization is stronger in the electronic sector, characterized by a major environmental dynamism. In fact, in the furniture and machine tools sector we observe the persistence of complete family groups even among the firms committed in joint ventures and foreign direct investments.

TAB. 4 RELATIONSHIP BETWEEN SINGLE INTERNATIONALIZATION FORMS AND STRUCTURE OF STRATEGIC DECISION MAKING GROUPS: DIRECT COMPARISON AMONG SECTORS
* SIGNIFICANCE AT THE 0.1 LEVEL; ** SIGNIFICANCE AT THE 0.05 LEVEL; *** SIGNIFICANCE AT 0.01 LEVEL

	%Closed family group	%Enlarged family group	%Open group	p-values
Partnerships electronics	16.5	16.5	67	
Partnerships m. tools	15	31	54	0.024352**
JV electronics	17	17	66	
JV m. tools	40	10	50	0.054573*
FDI electronics	0	20	80	
FDI m. tools	33	12	55	0.000001***
Partnerships electronics	16.5	16.5	67	
Partnerships furniture	54	10	36	0.000018***
JV electronics	17	17	66	
JV furniture	35	15	50	0.002032***
FDI	0	20	80	

electronics				
FDI furniture	30	15	55	0.000002***
Partnerships m. tools	15	31	54	
Partnerships furniture	54	10	36	0.000001***
JV m. tools	40	10	50	
JV furniture	35	15	50	0.513417
FDI m. tools	33	12	55	
FDI furniture	30	15	55	0.788128

According to hypothesis three this could be an effect of the effectiveness of the homogeneous strategic decision making groups in stable environments, but we could argue that other external effects play a relevant role. In particular, the network position and the complementarities with the bigger firms is important for the internationalization of the SMEs in the wood furniture sector. In the majority of cases these firms are of cases belong to industrial districts and their internationalization processes are often "pulled" by the leading firms that play the role of a "learning catalyst" for the whole system; moreover for these firms is often easy to replicate in the international context the cooperative behavior that characterizes the interorganizational relationships within the district [Compagno and Pittino, 2001]. With regard to the machine tools sector we could partly refer this result to the action of very effective entrepreneurial associations.

Conclusion

In this work we have investigated the relationship between corporate governance and firm level entrepreneurship in the small and medium enterprises, assuming the internationalization processes as corporate entrepreneurship activities. In fact, an important determinant of the internationalization paths of the small and medium enterprises is the adoption of a proactive and risk taking behavior, fundamental to pursue advanced international strategies and not only marked pulled initiatives. The opening of the governance structure, in particular through the active presence of non-family members in the strategic decision making groups, seems to have a positive impact on the implementation of advanced international strategies, enhancing the entrepreneurial posture of the firm through a "cultural change" in the leadership. Results suggest that industrial sector could be a moderating variable of the relationships between governance groups and internationalization: in more dynamic environments the heterogeneity in the strategic decision making groups seems to be necessary to adopt effective strategies. This relationship is less pronounced in more stable environments. We have found no support to the hypothesis that the presence of non family owners promotes internationalization. According to previous studies this could depend on the small dimension of the firms and on the fact that external owners often are not directly involved in the governance of the firm.

The principal limitations of this study concern the variables used to define the heterogeneity in governance groups: the exclusive involvement of non family members is not sufficient to define the degree of cultural heterogeneity and dynamism of the leadership. We should add other demographic variables, not available for this study, such as age, specific competences, previous experiences, organizational tenure. In addition, it would be interesting to investigate the effective group dynamics during the decision making process.

References

Contact the author for a list of references.

End Notes

[i] Data from the 2001 Report of the European Network for SME research (ENSR) "The European observatory for SMEs" EIM Small Business Research and Consultancy, Zoetermeer

[ii] Data from the Unioncamere (Association of Italian Chambers of Commerce) Report 2001 "Le piccole e medie imprese nell'economia Italiana" (Small and medium firms in the Italian Economy), edited by the Istituto Guglielmo Tagliacarne, Franco Angeli, Milano.

[iii][iii] Mediocredito centrale is a merchant bank. Data are collected every four years by the "Osservatorio sulle PMI italiane," that depends on the Mediocredito. The database is based on a representative sample of around 5000 Italian firms with more than 10 employees. Its aim is to gather information of qualitative and quantitative type concerning the Italian industrial system and in particular the small and medium enterprises.

Corporate Governance Reforms in France

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Abstract

Corporate governance has considerably changed since the early 1990s driven from a new legalistic, institutional and global environment. However, a new type of capitalist model did not emerge after the privatisation process and it did not really contribute to separate the public and private spheres. This paper addresses these issues by analysing the merits of the French corporate governance system and its degeneration.

Introduction

Since Berle and Means [1932] several authors tried to assess the competitive differences in the systems of corporate governance and the general hypothesis of convergence [Geoffron, 1997, 1999; O'Sullivan, 2000]. In general, authors consider the existence of two main systems: the Anglo-Saxon model and the Nippon-German model (see for e.g. Albert, 1991). Nevertheless, in the European context, several other authors consider the existence of other models like the French and other Southern European corporate governance models. Authors addressed the problems and specificities of corporate governance in the French corporate governance system [e.g. Bancel, 1997; Charreaux, 1997; Morin, 1996, 1998]

Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment [Shleifer & Vishny, 1996]. Corporate governance deals with the agency problem: the separation of management and finance. It has been a matter of great interest in the last few years. Over the last two decades, the effectiveness of institutional arrangements (boards of directors, CEO, shareholders) has been widely discussed in the United States and in Britain. To the extent that the subject is now commanding, albeit as yet limited, attention in France, the issues are being framed in terms that are largely derived of the Anglo-American debates. These debates have been dominated by a shareholder theory of corporate governance.

Historically, French companies have taken full advantage of the legal structure of the *société anonyme*. This legal structure limited the risks for shareholders who were not inclined to take an interest in the day-to-day activities of the firm [Alcouffe & Alcouffe, 2000]. The upper echelons of large French companies are recruited from a small number of *Grandes Ecoles* (ENA, Polytechic) and benefit from peer-network effects in boards and committees. Also, from the end of World War II, French corporate governance system is characterised by the dominance of the entrepreneurial role of the State. It dominated the entire economy through the extend power of owning and managing many state-owned enterprises in almost all of the domestic industries. In the middle 1980s and the beginning of 1990s, the privatisation process did not entail a truly rupture with the former system [Morin, 2000]. The privatisation process did not liberate the French economy from State influence. In fact, privatisation established a certain number of cross-shareholdings among the top main firms in which the influence of the State was still present. Nevertheless, starting in the 80s the internationalisation process of many top MNEs changed the nature and the structure of the main shareholdings.

Concentration of direct ownership and voting power is very high in France, both for non-listed and listed firms, and even for CAC40 firms. The largest direct owner of non-listed firms owns 66 per cent of the capital. The degree of concentration is a little lower for listed firms but still very large: the share of largest identified stake is 52 percent, over half of the capital. The largest direct owner or the largest voting blockholder of the CAC40 firms holds around 20-30 per cent and has the control in facts of the company.

Families seem to play an important role in ownership and voting power, both in unlisted firms and in the CAC40 firms. Around 40 per cent of unlisted firms have, as first shareholder, individuals owning directly more than

50 per cent of the capital. For the CAC40 firms, individuals are not the largest blockholder, but when they effectively are present as blockholders, they hold around 30 per cent of the voting rights and have the control in facts. These results confirm and complete La Porta and al. [1998] main conclusions on the top 20 firms at the end of 1995, that firms with controlling shareholders rarely have other large shareholders, and that family control is rather common.

In the second half of the 1990s, the rise of institutional investors and the adoption of a new legal setting reoriented French capitalism towards more transparency and accountability. However, in certain areas like executive pay it is still characterized by little systematic disclosure [Alcouffe & Alcouffe, 2000].

A new type of capitalist model did not emerge after the privatisation process and it did not really contribute to separate the public and private spheres. This paper addresses these issues by analysing the merits of the French corporate governance system and its degeneration.

The paper is structured as follows. Part 1, presents a brief outline of the main characteristics of the French corporate governance system. Part 2 is focused in the dynamics of the evolution of the legalistic environment of corporate governance (French civil law and major legal reforms). The changes in the institutional environment are discussed in part 3 (shareholdings specificity and *elitisme*). Finally, part 4 deals with the pressures to change and its influence over the French corporate governance system. At the end, we discuss some key issues arising from the actual evolution of corporate governance in France.

An Outline of French Capitalism

From the end of World War II, French corporate governance system is characterised by the dominance of the entrepreneurial role of the State. It dominated the entire economy through the extend power of owning and managing many state-owned enterprises in almost all of the domestic industries. In the middle 1980s and the beginning of the 1990s, the privatisation process did not entail a truly rupture with the former system. The privatisation process did not liberate the French economy from State influence. In fact, privatisation established a certain number of cross-shareholdings among the top main firms in which the influence of the State was still present. However, more recently, France constitutes an excellent case study because the country has undergone from a major transformation in the last decade, shifting from an insider to an outsider model of corporate governance, and introducing various monitoring mechanisms borrowed from its Anglo-Saxon counterparts.

Bloch and Kremp [1999] by looking at listed firms and CAC 40 firms, and at a large dataset of unlisted firms, they show that concentration and direct ownership and voting power is very high in France, even for listed and CAC 40 firms. The second direct owner lags far behind the first one and the category «families» plays a major role in the detention of non-listed firms. The average ownership stakes of banks insurance companies and other financial institutions are relatively low, except for CAC 40 firms.

Concentration of direct ownership and voting power is very high in France, both for non-listed and listed firms, and even for CAC 40 firms. The largest direct owner of non-listed firms owns 66 per cent of the capital. The degree of concentration is a little lower for listed firms but still very large: the share of largest identified stake is 52 per cent, over half of the capital. The largest direct owner or the largest voting blockholder of the CAC 40 firms holds around 20-30 per cent and has the control in facts of the company.

Families seem to play an important role in ownership and voting power, both in unlisted firms and in the CAC40 firms. Around 40 per cent of unlisted firms have, as first shareholder, individuals owning directly more than 50 per cent of the capital. For the CAC 40 firms, individuals are not the largest blockholder, but when they effectively are present as blockholders, they hold around 30 per cent of the voting rights and have the control in facts. These results confirm and complete La Porta and alii [1998] main conclusions on the top 20 firms at the end of 1995, that firms with controlling shareholders rarely have other large shareholders, and that family control is rather common.

One of the main criticisms addressed to the French corporate system during the 90s was that due to its inefficiency it proved not to be able to transform into a new type of capitalist model after the privatisation process and it did not really contributed to separate the public and private spheres. It is argued that the French corporate governance system served to promote the interests and priorities of the main actor in the innovation system – the state until the mid-1980s or the large firm since then [Goyer, 2001].

The transformation of the French system of corporate governance is nothing short of impressive: in less than a decade, France shifted from an insider to an outsider model. As a result, the ability of the French system of corporate governance to support incremental innovation is severely limited. The new institutional arrangements of the French system of corporate governance are ill suited to encourage trust and commitment between the various stakeholders inside and outside the corporation. They are structured to better defend the interests of shareholders- which are increasingly Anglo-Saxon institutional investors.

The nature and process of the transformation of the French system of corporate governance is interesting at three levels:

a) first, the globalisation of financial markets and the rise of the Anglo-Saxon investors as shareholders have not led to a convergence across industrialised nations. Prior to the advent of financial liberalisation, Germany and Japan were insider systems of corporate governance whose main source of external finance was debt. Despite being subjected to the same types of stimu lus as France, the corporate governance systems of these two countries have exhibited remarkable resilience;
b) second, the pattern of foreign ownership concentration in France raises some serious doubts about the apparent omnipotence of the Anglo-Saxon institutional investors. For only six CAC 40 firms the percentage of combined ownership of the top three foreign institutional investors superior to 5 percent. The breakdown of the combined equity stake held by the largest three Anglo-Saxon institutional investors in the remaining 34 CAC 40 firms is the following: between 4 and 5 percent (2), between 3 and 4 percent (3), between 2 and 3 percent (1), between 1 and 2 percent (14) and less than 1 percent (11);
c) third, the pattern of economic specialisation of French enterprises reveals a potential timing inconsistency between the French system of corporate governance and the structure of innovation. Data on the innovation process reveal that, as early as 1983, French firms had a profile of economic specialisation similar to that of the USA and UK. Moreover, this pattern of economic specialisation amplified between 1983 and 1992. By contrast, the transformation of the French system of corporate governance toward an outsider model is a recent phenomenon.

To deal with the economics of innovation, a theory of corporate governance must come to terms with the reality of a resource allocation process that is developmental, organisational and strategic. Thus it must explain how, at any point in time, a system of corporate governance generates institutional conditions that support:
1) the commitment of resources to irreversible investments with uncertain returns ;
2) the integration of human and physical resources into an organisational process to develop and utilise technology ;
3) the vesting of strategic control within corporations in the hands of those with the incentives and abilities to allocate resources to innovative investments.

To date, research on the relationship between the process of innovation and corporate govern ance has been limited because the leading theories of corporate governance do not systematically integrate an analysis of the economics of innovation [O'Sullivan, 2000].

Estimations of 1997 stocks held by foreign investors in French companies are around 35% of the CAC 40 index. These figures had a strong increase in the last few years : from 11% in 1997 to 23% in 1993 of the capitalisation of the CAC 40 index [Baudru & Kechidi, 1998].

The previous discussion has raised two fundamental points that characterize the process of change in France. First, the transformation of corporate governance is recent and nationally specific. The globalisation of finance does not entail the transformation of every insider system of corporate governance. Second, the innovation and corporate governance systems had been divorced for many years. As late as 1992, the institutional features of corporate governance were supportive of the firms capabilities associated with incremental innovation while the pattern of economic specialis ation of large firms was similar to those of the USA and the UK.

The balance of this section will account for this apparent paradox by examining the development of innovative capabilities of French firms over two periods: the period of massive state intervention (from 1958 until the mid-1980s) and the process of adjustment following the retreat of the State.

From 1958 to mid-1980s the impact of state intervention on the innovative capabilities of firms made them ill equipped to succeed in areas of incremental innovation. This does not imply that French companies were necessarily well endowed to proceed in every area of radical innovation. Instead, this work emphasizes that organisational structures and management styles required for production and technologies in incremental innovation niches were absent in France. What characterized the French innovation system on the eve of the withdrawal of the State from its traditional highly interventionist role? In the mid-1980's, the French system of corporate governance shared several characteristics with the insider models. In this regard, the institutional features of the system if corporate governance were conducive to incremental innovation. However, other institutional features of the French innovation system did not encourage incremental innovation during the period of economic dirigisme. The educational formation and the role of knowledge-bearing elites promoted the development of large, «mission-oriented» efforts to develop specific technologies. The access to patient capital and the highly visible nature of the tasks at hand facilitated the undertaking and successful completion of radical innovation projects. By contrast to German firms, French corporations exhibit little ability to succeed at low visibility projects. The concentration of power at the top of French firms reduced their capability to monitor innovation carried out in numerous subdivisions. In addition, there was a sharp division of responsibilities between academia and the various state mission-oriented scientific agencies – the latter having the task of developing scientific and technological activities in numerous public policy fields. The role of the system of corporate governance in this specific innovation context was different from its traditional assigned task of either promoting risk taking and developing new competencies (radical) or encouraging the development of credibility and trust between the firm and its stakeholders (incremental).

Given the dominant role played by the State in France, its eventual withdrawal created a deep crisis in the national innovation system. Moreover, the legacy of State intervention had left domestic firms ill prepared for international competition. As a result, the French corporate sector was suffering from a competitiveness crisis in the mi-1980s. The innovative capabilities of French firms did not allow them to compete either on the basis of price or on the quality of products.

How did French firms restructure themselves?. A substantial redrawing of their relationships with banks, suppliers, fellow firms, and their workforce provides part of the answer. Large French firms took advantage of the failed government reforms of the 1980s – in labour relations, finance, and decentralization – to restructure their competitive environment. This economic adjustment process was made possible by the autonomy of management of large firms from both state and capital markets. The restructuring of the French industry was a process led by large firms. The process of economic restructuring in France hinged on the development of core competencies via mergers and acquisitions (M&A) in radical innovation markets. The process of economic restructuring in France was also accompanied by external growth: large firms develop radical innovation capabilities through M&A in the USA and in the UK. This pattern of external growth solved various problems associated with French institutional framework of incentives and constraints.

In France, a New Economic Law[i] tried to reform some of the devices of monitoring and control of managers and to improve corporate efficiency. One of its main goals was to improve transparency through the obligation of publishing the amount of managers' remunerations in listed companies.

In general, the change toward decentralisation in French firms, together with decreasing cross-shareholding, is considered to be a development in the direction of the Anglo-Saxon model, implying a reduction of *Président Directeur Général* - Pdg's power and an increase shareholder power. However, taking the specific position of Pdg's power and the relationship with stable shareholders into account seems that although decentralisation of managerial decision-making has occurred at lower levels of the hierarchy, major decisions still remain in the hands of the CEO, who, given the increasing size and internationalisation of French industry along with the restructuring of ownership and control, has now a great deal more power than in the past [Schmidt, 1996]. So, it is not the shareholder, but the Pdg who has more power. The persistence of the importance of the educational system and the value of individualism (*logique d'honneur*), combined with the inclination to centralisation have had a large impact on how recent changes in corporate governance are absorbed by the system. The domains are still controlled by the *Corps d'État*, which means that M&A, shareholder power, and the influence of politicians can only be understood in that specific context.

The Legalistic Approach

French Civil Law System

Corporate governance reform efforts have generated considerable attention in France in the past decade due: to the privatization of government-owned entities; a slow unravelling of cross-shareholdings among corporations, banks and insurance companies; and, increased activism by both institutional and individual shareholders. In addition, the private sector has undertaken voluntary reforms in an effort to avoid legislation. The governance code issued in 1995 by a committee chaired by Marc Viénot played a significant role in encouraging voluntary reform. Legislated reforms have also emerged, most notably in the *Loi relative aux Nouvelles Régulations Economiques* adopted on 15 May 2001 (NRE Act).

The principal business entities under French law are the *société anonyme* ("SA"), a form used primarily for large publicly-held companies, and the *société à responsabilité limitée* ("SARL"), a form used by more closely held limited liability companies having fifty or fewer shareholders. (The SA is similar to the Germany AG and the United Kingdom's plc). The SARL is similar to the GmbH in Germany and the Ltd. in the UK). Another company structure is the *société en commandie par actions* (limited partnership), which is used by large family-controlled companies to retain control while assessing the equity markets. A specialised corporate form, the *société par actions simplifiée* ("SAS") was created in 1994. The SAS is intended to provide more flexible structure for management and administration of large private commercial corporation than the SA regime.

Other forms of commercial business entities are available under French law, including the *société en nom collectif* (general partnership) and the *société civile* (civil company). They function in a manner different from SAs, SASs, and SARLs and are subject to different rules. According to French law, all these types of entities have their own legal entity separate from the shareholders and partners.

La Porta et al. [1997] provided the basis for analysing the strengths and weaknesses of the various corporate governance systems around the world. Based on their approach, the French system is characterized as follows (see Table 1):

TABLE 1 - LAW AND FINANCE IN FRANCE

Country	# of Domestic Firms / Population	IPOs / Population	Ownership Concentration	Anti-Director Rights	Creditor Rights	Efficiency of Judicial System	Rule of Law
France	**8.05**	**0.17**	**0.34**	**3.00**	**0.00**	**8.00**	**8.98**
Italy	3.91	0.31	0.58	1.00	2.00	6.75	8.33
Portugal	19.50	0.50	0.52	3.00	1.00	5.50	8.68
Spain	9.71	0.07	0.51	4.00	2.00	6.25	7.80
Germany	5.14	0.08	0.48	1.00	3.00	9.00	9.23
Japan	17.78	0.26	0.18	3.00	2.00	10.00	8.98
US	30.11	3.11	0.20	5.00	1.00	10.00	10.00
UK	35.68	2.01	0.19	4.00	4.00	10.00	8.57
Average	*16,235*	*0,81*	*0.375*	*3*	*1,875*	*8,19*	*8,82*

Average is for all 49 countries included in La Porta et al.(1997).

?? *Domestic Firms:Pop*. Is the ration of the domestic firms listed in a given country to its population in 1994.
?? *IPOs/Population* is the ratio of initial public offerings of equity in a given country to its population.
?? *Ownership Concentration* is the average percentage of common shares owned by the three largest shareholders in the ten largest, non-financial, privately owned domestic firms in a given country.
?? *Anti-Director Rights* is an index that indicates shareholder rights and ranges from 0 to 5 representing best protected shareholder rights.
?? *Creditor Rights* in an index that ranges from 0 to 4, with 4 representing the best protected creditor rights.
?? *Efficiency of the Judicial System* is the assessment of the efficiency and integrity of the legal environment as it affects business, particularly foreign firms produced by Business International Corporation (scale from 0 to 10, with lower scores indicating lower efficiency levels).
?? *Rule of Law* is the assessment of the law and order tradition in the country produced by the risk-rating agency International Country Risk (average between 1982 and 1995, scale from 0 to 10, with lower score for less tradition of law and order).

Source: *La Porta, Lopez-de-Silanes, Shleifer, and Vishny* [1997, 1998].

The data provided by the table above indicate that the French system of corporate governance is characterized by low ownership concentration and low pressure from market mechanisms. Creditor rights are unprotected.

Indeed, the successful corporate governance systems, such as those of the United States, Germany and Japan, rely on some combinations of concentrated ownership and legal protection of investors. In much of the rest of the world, legal protection of investors is less substantial, either because laws are bad or because courts do not enforce these laws. As a consequence, firms remain family-controlled and, even in some of the richest countries, have difficulty rising outside funds, and finance most of their investment internally [Mayer, 1990].

Although there is little systematic evidence available, most of the world appears to be more like France than like the United States, Germany or Japan. So we can assume that corporate governance systems of the United States, Germany and Japan have more in common than is typically thought namely a combination of large investors and a legal system that protects their rights. Corporate governance systems elsewhere are less effective because they lack the necessary legal protections.

The effects of any given mix of corporate governance devices can be evaluated on two different grounds: *static efficiency*, i.e. the ability to carry an allocation of control as close as possible, given the skills and technology of all agents, to efficiency (i.e. maximising innovation and human capital investments); and *dynamic efficiency*, i.e. the ability to guarantee a degree a of control mobility that creates enough of an incentive for people to improve their skills, given their endowment of talents. In the context of the French corporate governance systems two conditions seem essential to supplant the obsolete devices: the privatisation process – initiated in the 1990s – and the emergence of control-oriented activist financial institutions. These processes are under way and are far from being achieved.

French Corporate Governance Reforms

France has been moving in the direction of incorporation accepted principles of corporate governance into law for several years. Recently adopted recommendations and requirements in France were the following:

Viénot I Report

In July 1995, two of the leading French business authorities, the AFEP (*Association Française des Entreprises Privées*) and the MEDEF (*Mouvement des Entreprises de France*) requested a panel composed of CEOs of 14 major public companies to issue a report promoting non-binding corporate governance principles. The report focused on the composition, functioning and duties of the Board of Directors of French listed companies.

Viénot II Report

In July 1999, as advocated by the Viénot I Report and at the request of the AFEP and MEDEF, the same panel reviewed effective implementation of these principles in French listed companies. The report reiterated the Viénot I report's recommendations and emphasized on new non-binding principles regarding Director compensation, stock-options and Director independence.

Bouton Report

In reaction to the Enron and Vivendi Universal scandals, the AFEP and MEDEF requested the same panel to re-examine application in France of corporate governance principles. The report issued on 2002, contained stricter recommendations regarding Directors' independence, Committees' roles, Statutory Auditor's independency and financial information.

Corporate governance has certainly been improved in France by the two reports prepared by a commission headed by Marc Viénot, in 1995 and 1999, which are seen as the political and intellectual preparation for significant reform of French company law. As a result of these reports, substantial changes in French company law were enacted.

Although the recommendations advocated in these 3 reports are non-binding, French listed companies are strongly encouraged to comply with them by the end of 2003. Some of these recommendations were also given a binding effect due to their inclusion in Statute n°. 2001-420 on so-called "New Economic Regulations" or in the rulings issued by the *Commission des Opérations de Bourse* (which is the French equivalent to the SEC).

Nonetheless, some important points in French law will remain problematic for foreign investors and also French shareholders who more and more are demanding a higher level of professionalism, accountability and transparency in the companies in which they invest.

Among the areas in which work needs to be done is the staggering of boards of directors: shares with unequal voting rights; the lack of a formal requirement to have independent directors on the boards; and committees which should be further empowered.

Nonetheless, even within the existing framework, there is a multiplicity of mechanisms by which shareholders, other stakeholders (including suppliers, clients, employees and others) and officers and directors themselves can demand constantly improving disclosure, responsibility, and, when all else fails, sanctions for egregious behaviour.

Changes in the Institutional Environment

Blockholdings and Cross-Shareholdings in France

Concentration of shareholdings in Continental Europe is one of the main distinctive features of corporate governance compared with the U.S. and the U.K. Thus the relationship between large controlling shareholders and weak minority shareholders is an important research subject. While in the U.S. the main agency problem seem to stem from conflicts between managers and dispersed, insufficiently interventionist shareholders, in much of the continental Europe there are large blockholders present who can and do exercise of control over management. Instead, the main potential conflict of interest lies between controlling shareholders and powerless minority shareholders [Becht & Röell, 1999]. Within Europe, the level of concentration of voting power is by no means uniform; and these differences are rooted in differences in customs and the legal environment in different countries. For example, in Italy, France and Belgium, pyramidal holding company groups are a preferred method of amassing voting power without concentrating (cash flow).

Elite Coordination, Endogamy and Metamorphosis

The elite coordinating mechanism, which tied the large companies to the state, provided the conditions for management autonomy from both the state and the stock market. The set-up was one in which top management was sealed off from the rest of the company, but tightly linked to the administrative apparatus. The privatisations of the 1980s and of the 1990s, grafted themselves upon this system, but led to a profound change in the way it operated. Because of how the privatisations took place, they created a protective circle of core shareholders, giving the CEO more autonomy from the state while protecting the company against takeovers. If the state was able to directly influence decision-making in large companies before, the changes in ownership structure made that much harder in the future. The hard core of investors that grew out of the privatization process simultaneously became the central point of reference for management action, and offered protection against invasive initiatives by the state.

Pressures to Change: the Dynamics of Corporate Governance

The elements of change have already emerged in the process described above, and the effects of globalization were explicitly part of the mandate of the Viénot I & II, Bouton reports and the Law of NRE. The pressures to change can be divided into four main issues, whose main impact is the reduction of economic and cultural idiosyncrasies, the internationalization of competitions and the growing importance of the stock markets:

a) the growing role of foreign institutional investors;
b) the integration of capital markets;
c) shareholder activism;
d) privatizations underway

Institutional investors are increasing their shareholdings in most of the companies and France is not an exception. This issue provoked an intense debate due to developments in retirement financing and healthcare.

First of all, the introduction of the Euro currency and the globalization of the monetary and financial markets accelerated capital flows. The arrival of this new type of investors provoked a sharp increasing in the CAC 40 stockholdings. Morin [2000, p. 28] reports an increasing from 10% in 1985 to 35% in 1997. By 2001, a survey conducted by the American firm Georgeson Shareholder related to the presence of foreign investors in the shareholdings of 65 companies presents in the CAC 40 and EUROSTOXX 52 concluded that 45.57% of the ownership was owned by foreign investors.

This analysis led to two main conclusions:

- the presence of foreign investors is strong in the Euroland countries and mainly in France (44,9% of the stockholdings). It accounts for 1154,4 billion Euros and the participation of institutional Anglo-Saxon represents 22,95%, i.e. 598,17 billion Euros.

However, the shareholdings held by foreign investors in the CAC 40 index is more important (45, 57 percent) if one excludes the France Telecom and Orange shareholdings, whose majority is held by the state. This results are quite different from those obtained in the U.K. for the London Stock Exchange (29.3%) and in the U.S. for Wallstreet (less than 10 percent).

Secondly, the presence of foreign investors in France is increasing over the time. Since 1997, some of the companies like Vivendi, AGF or Elf Aquitaine opened their ownership to the Anglo-Saxon pension funds. For example, in three years, the part of the capital held by Vivendi increased from 42% to 61% and for AGF from 42% to 73.4% and for TotalfinaElf, from 51% to 65% of the overall shareholdings.

Conclusion

Corporate governance has become a topical issue in many European countries in recent years. Despite there was being much conventional wisdom about the different systems of corporate governance, many questions remains on how the French and, at a larger extent, how the European scene will evolve. This paper reviews the main reforms and institutional driving forces of corporate governance in France.

The role of national institutions, however, is particularly useful in explaining the directions of change. In France, the mixtures of constraining and enabling institutional features have shaped the choice of strategy by top management (*elites*).. From detailed institutional analysis based on knowledge of institutional specificities, the French case shows that changes are absorbed and molded by existing institutions, which make the consequences for the system as a whole specifically "French". In other words, the direction of change looks similar, but the consequences are diverse.

The French system of ownership and management of equity is confronted by three problems: the very marked presence of Anglo-Saxon institutional investors in the ownership structures of largest companies; an absence of national investors who are able to mobilize long-term savings; and a system of retirement which depends on the distribution of funds. These problems are exacerbated by the desire of French government to reform retirement pensions around a new social compromise, whereby state pensions to individuals are to be supplemented by private pensions.

The process of refocusing in the core business of the main companies in France also provides some support for the functional convergence perspective on corporate governance. Compared with Germany, the process of refocusing was not negotiated, but unilaterally determined [Goyer, 2002]. This led to the adoption of major restructurings in companies and to social conflicts (Danone and Michelin were two of the problematic cases).

The process of change does matter for the transformation of national systems of corporate governance as it sends companies and nations along a path dependent transition. The occurrence of functional convergence is more difficult to achieve than that of institutional convergence [Gilson, 2001].

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Corporate Governance - Who Governs and How

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Abstract

We must be clear about one thing: investors are the owners, while directors and managers work for the owners. Even though CEO's are fully aware of the importance of long term investor loyalty, we should perhaps ask how loyal management is to stockholders. Are the decisions made by directors and managers inspired by the desire to increase share value? If this is not the case, then company directors and managers have the wrong objective.

Good corporate governance adds value to short term company development, while also generating increased share price value elements. Consequently, good corporate governance identifies and reduces the possibility of risks arising from negative events that limit or reduce the achievement of business objectives.

Unfortunately, throughout the international business world, there are a large number of frequent business practices that effectively prevent the implementation of corrective measures by board members and stockholders.

Definition and Background of Corporate Governance

As a general point of departure, we will define Corporate Governance as a mechanism established by the stockholders' meeting to act as a management counterweight and guide to ensure proper efficiency levels, while guaranteeing the timely distribution of quality information on the company's financial and operating conditions.

Through good corporate governance, interests become aligned, responsibilities distributed, conflicts identified and made known, to enable their follow-up and resolution.

However, managing corporate governance does not imply a double management scheme, but rather a strengthened management with a development follow-up, advice and support process to enhance company results.

In May 1999, the Organization for Economic Cooperation and Development (OECD) issued its corporate governance principles which, in general terms, establish the following:

A company's corporate governance framework must:

?? Protect and ensure equal treatment for all stockholders, including minority or foreign stockholders
?? Recognize the rights of interested third parties
?? Precisely and timely disclose material issues with an influence on the achievement of business objectives
?? Act as a strategic, effective guide to monitor company management

The Code of Best Practices issued by different countries, including Mexico, is essentially based on the OECD provisions. The specific functions of the members of the Board of Directors differ according to the laws of each country and the corporate bylaws of each company. However, the following points must nonetheless be observed:

?? Review and management of the corporate strategy, main action plans, risk policy, annual budgets, business plans, the establishment of management team performance objectives, corporate performance monitoring, main expense supervision, investment and disinvestment.
?? The selection, compensation, monitoring, replacement of key executives and supervision of succession plans.
?? Review the remunerations of key executives and board members, ensuring that the latter are nominated in a formal and transparent manner.
?? Supervision and arbitration regarding conflicts of interest affecting top management, members of the board of directors and stockholders, including the misuse of company assets and abuse of transactions between related parties.
?? Assurance regarding the completeness of company accounting and financial information, including External Audit, systems.

?? Ensure the existence of an adequate internal control infrastructure to meet organizational needs and guarantee effective risk management and control.
?? Create an Audit Committee to ensure effective corporate governance practices and permit proper company management supervision.
?? Ascertain and supervise proper process documentation and the respective compliance levels.
?? Supervise regulatory compliance levels.
?? Ensure the existence of an adequate, appropriate process for disclosing information within and outside the company.

Reasons behind Corporate Governance

We must recognize that CEO's may have a different position regarding certain important organizational concepts, such as recognizing and distributing profits, managing liabilities or asset values. This situation necessarily leads us to a convergence of different positions, thus enabling us to reconcile interests by adopting the measures most favoring the organization's transparency, stability, profitability and development.

Corporate objectives naturally implying a certain degree of conflict between company management and stockholders include the following:
?? Who controls the company and how this control is exercised; which measurement framework is utilized to determine business efficiency or effectiveness.
?? What is the structure and nature of the company's capital, investments in assets, and liabilities.
?? This year's expected profitability vs. that of future years.
?? How Management should be compensated.
?? The appointment of directors
?? Stockholders' and board memb ers' business management rights.

Who Governs and How

We must be clear about one thing: investors are the owners, while directors and managers work for the owners. Even though CEO's are fully aware of the importance of long term investor loyalty, we should perhaps ask how loyal management is to stockholders. Are the decisions made by directors and managers inspired by the desire to increase share value? If this is not the case, then company directors and managers have the wrong objective.

In itself, good corporate governance adds value to short term company development, while also generating increased share price value elements. Consequently, good corporate governance identifies and reduces the possibility of risks arising from negative events that limit or reduce the achievement of business objectives.

Business Failures

Nowadays, it is a fact that many businessmen who accept positions as board members and members of corporate committees are exposed to the possibility of legal action filed by stockholders, the authorities or general investing public. Although these positions are normally accepted based on professional recognition or friendship, in most cases, this is really a formality as company information is neither obtained nor properly analyzed. Without such information, members of corporate committees are unable to make decisions, participate and act in such a way as to manage and direct the company towards secure, efficient evolution.

A stock market that has recently undergone different financial earthquakes, like the recent cases of Enron or World Comm, seriously threatens savers' confidence. However, it is unfortunately a fact that such crimes are not isolated cases; indeed, they constantly take place on a greater or lesser scale, with varying degre es of publicity. Their real effects are not only felt on the stock market, but also in the microeconomic stability of millions of families that depend on the corporate well-being of directly or indirectly related companies.

Although the implementation and operation of professional, independent corporate governance is a regulatory obligation for many companies in Mexico, the United States and other countries worldwide, this effort should nonetheless be made for essential business reasons. Intermediation committees like the Audit Committee must be implemented according to a formula that ensures access to the analysis of all critical company information and, accordingly, the secure, high-yield practice and exercise of corporate governance.

Common Conditions of Business Failure Experiences

We frequently hear of corporate business failures that lead us to focus on the weakness of certain beliefs and paradigms upon which management and leadership functions were based. In fact, we constantly hear of companies that have lost considerable amounts, have gone bankrupt or have been sanctioned. We must therefore identify the common symptoms or conditions that traditionally arise in such cases.

Highly Recurrent Identified Irregularities

Unfortunately, in the business world prevailing in Mexico and abroad, there are a large number of frequent business practices that effectively prevent the implementation of corrective measures by board members and stockholders, thus leading to significant business failures. These factors include:

?? Overestimating the cost of restructuring to satisfy future estimated profits.
?? Inappropriate penalties.
?? Accumulating excessive reserves or provisions in good times for application in less favorable ones.
?? Premature revenue recognition.
?? Inadequate expense deferment.
?? Misuse of the materiality concept for accounting manipulation purposes.
?? Hiding losses or falling profit margins.
?? Insecure and uncontrolled credit and treasury practices.
?? An inadequate collection process and a considerable degree of immobilization.
?? An incorrect and inconsistent business strategy and practice.
?? The implementation and/or operation of inefficient, duplicate, costly and obsolete processes.

Circumstances Favoring or Preceding Corporate Failure

The risk conditions or circumstances that generally facilitate, precede and/or favor corporate failure include:
Strategic conditions:

?? Lack of an independent opinion on businesses operating progress.
?? Insufficient information/disclosure in the company's financial statements.
?? Adaptation of figures by management to reflect the best possible performance level.
?? Overestimation of the external audit scope
?? Board members without real participation
?? Audit Committees without organizational influence or added value

Operating conditions:

?? Operating circumstances that primarily lead to figure alteration include the following:

Inadequate financial stability due to economic threats to the industry or operating conditions of the entity, such as:

?? Reduction of margins subject to a high level of competition and saturation
?? A high degree of vulnerability derived from rapid change
?? Production of customer demand and increasing business failures
?? Operating losses with the threat of bankruptcy
?? Frequent negative cash flow, while reporting profits

?? Unusual profit growth that is not comparable with that of similar companies

Excessive pressure on management to fulfill third party requirements or expectations, based on:

?? Aggressive or unrealistic profit expectations.
?? The need to obtain additional credit lines.
?? Low amortization and interest payment capacity.

Income of directors and managers either threatened or proportional to company development:

?? Higher income concentration depending on the company's performance.
?? Significant amounts paid in special profit bonuses and stock options.
?? Personal guarantees given for debts contracted by the entity.

Nature of Company Transactions Susceptible to Fraud:

?? Assignment of unlimited powers or limits in excess of those required.
?? Excessive control procedures (registration, custody, authorization, disposal - use)
?? Unaudited transactions with related parties.
?? Records based on estimates that are either subjective or hard to corroborate.
?? Complex or unusual transactions, especially at yearend.
?? Substantial bank accounts in tax havens without a business justification.

Inadequate management monitoring:

?? Management dominated by a single person or group of people without counterbalancing controls.
?? Ineffectiveness of the Board of Directors and/or Audit Committee when evaluating the financial statements and internal control infrastructure.
?? High management turnover.
?? Complex organizational structure without clear lines of responsibility.
?? Ineffective accounting and information systems with a substantial manual report preparation component.

Management Attitude:

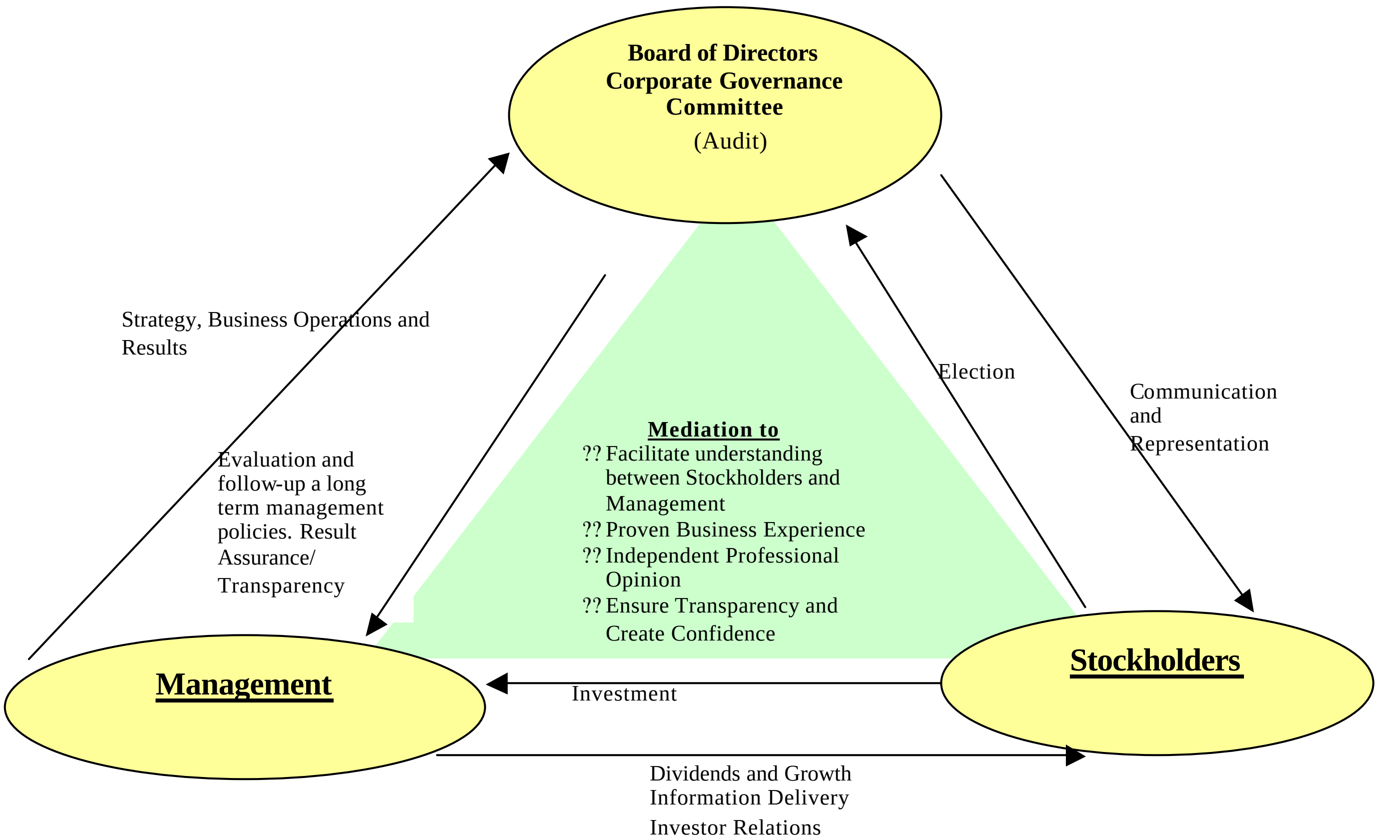
?? Inadequate business ethics practices and communications.
?? Excessive concern with the application of accounting principles.
?? A known history of management's nonfulfillment of regulations.
?? Excessive management interest in maintaining and increasing the share value.
?? Management interest in using inappropriate means to minimize the tax burden.
?? Insistence on applying inappropriate accounting practices, justifying this position based on materiality.
?? Constant management intervention with auditors to influence their scope, samples and opinions.
?? An inadequate segregation of functions, unlimited powers and the ability to appropriate assets.
?? Little value is given to the implementation and operation of corporate control mechanisms, while also maintaining an attitude of general dissatisfaction and criticism towards them.
?? Changes in standards of living that are incongruous with income earned.
?? Inadequate financial stability due to economic threats to the industry or operating conditions of the entity.
?? Excessive pressure on management to fulfill third party requirements or expectations.
?? The income of directors and managers is either threatened or directly proportional to company development.
?? The nature of company transactions is susceptible to fraud.
?? Inadequate management monitoring.
?? Management's high-risk attitude.

Corporate Governance Triangle

The Corporate Governance thesis means achieving a virtuous triangle which, in turn, permits the development of a highly-professional, stable relationship in which management has a clear guide and is properly listened to, the company's main critical conditions are known and studied, and the best possible response options proposed.

This does not mean establishing a double management scheme, but rather developing an effective, strengthened management with a clear notion of stockholders' expectations and the support needed to promote business actions required to achieve higher levels of efficiency, productivity and transparency.

The relationship between management, the Board of Directors (Corporate Governance) and stockholders is detailed below.



The corporate governance triangle allows us to clearly identify the different interrelations between stockholders, the Board of Directors and company management, while also constituting the main reason for Corporate Governance.

Corporate Governance Committee

For many years, board members and their Audit Committees have played an important role in management supervision responsibilities. In fact, Audit Committees have been necessary for long time; companies quoted on the New York Stock Exchange have been subject to this obligation since 1978, which was actually promoted by the Securities and Exchange Commission as of 1940.

The importance of the Audit Committee in achieving corporate governance has recently been highlighted by authorities worldwide, as well as by professional organizations like the Treadway Commission, General Accounting Office, American Law Institute, Public Oversight Board, AICPA and Congress in the United States, and the Securities Law and National Banking and Securities Commission in Mexico.

Furthermore, in September 1998, Arthur Levitt –SEC Committee Chairman– requested that the National Association of Securities Dealers of the New York Stock Exchange create the "Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees". The respective report was issued in February 1999; since this time, a large number of declarations and proposals have been issued to facilitate implementation of the best practices established in the report. As expectations regarding the effective participation of Audit Committees are extremely high, members of the board and Audit Committees must receive information on specific actions and best practices to be applied, to enable them to achieve a simple, yet efficient participation process that generates high added value.

Responding to high expectations undoubtedly requires a clear perspective of the business and type of responses required. In fact, this perspective must serve as a compass guiding Committee actions, enabling it to determine which issues must be reconsidered and those that can be discarded due to their minimal importance, risk or impact on the organization's interests. The type and scope of responsibilities undertaken by Audit Committees, their Chairman or members can vary from one company to the next depending on the particular circumstances of each.

The Code of Best Practices was published in Mexico in 1999; per article 33 of the Securities Law, the Code is mandatory for companies quoted on the Stock Market. According to the statistics of Mexico's National Banking and Securities Commission from August 2003, 76% of companies have responded to these recommendations. Similarly, an average 70% compliance rate with the Code's principles has been recorded; the average percentages reported have increased on a yearly basis.

The importance of the activities assigned to the Audit Committee and its need to ascertain the correct operation of other committees like the "Related Parties Committee", the "Planning and Finance Committee" or the "Compensations and Remunerations Committee", leads us to believe that the Audit Committee could actually be termed as the Corporate Governance Committee. Notwithstanding, this situation clearly depends on the specific configuration and requirements of each organization.

Supporting the Corporate Governance Committee

As it might seem that board members do not have enough time and, in many cases, the information and methodology needed to fulfill their responsibilities, it is vitally important that board members implement and support the operation of a Corporate Governance Committee. In turn, the Committee must receive support from a work group –specialists able to ensure and facilitate the proper performance of its duties by simplifying board members' knowledge of and follow-up on pending issues. Corporate governance means owners, directors and personnel working together to ensure the company's proper development.

Business Perspective with Control Methodologies and Best Practices

We must also understand that the essential transformation of the Audit Committee is based on the integration of a clear business perspective. It is not enough to simply implement international best practice methodologies, as in-depth knowledge and the experience of how to operate the business and where the real secrets of its success lie, are also crucial. Traditionally, this experience has been held by the figure of the Committee Chairman and/or Committee members, and is complemented by international best practices and a support group that permit the required identification and analysis of critical information.

Corporate Governance Committee Characteristics

The issue of Committee independence has traditionally been controversial. Committee members frequently include executives with operating duties or who have family ties with people responsible for company operations. Is not humanly possible for a person to evaluate and/or analyze an organization from an independent standpoint if involved in its operations.

Consequently, the most important quality of the Committee lies in its independence, due to the need for an additional opinion rather than the perspective of people who are directly involved in the operating process. This additional opinion is extremely valuable because Committee members are traditionally people with extensive business experience who, free from daily operating pressures, are able to assimilate the necessary information to enable them to jointly analyze business circumstances and make recommendations with effective added value for the company.

When we speak of Committee meetings, we are not simply referring to the narration of company circumstances, but rather a forum for in-depth analysis based on different business experiences, to generate opportunities for the company and processes embodying increased security and productivity levels.

As we can see, the possibility of generating valuable recommendations primarily lies in the following characteristics of Committee members and other participants:

- Business experience and creativity
- Business perspective
- Independence regarding the business issue under evaluation
- Free, unlimited expression of opinions
- Time to analyze issues and present recommendations
- Executive-level information and synthesis regarding business circumstances

Accordingly, the Committee must not be understood as a forum that simply criticizes management; indeed, any such tendencies must be quickly eliminated. The search for the common good, including profitability, security and quality service, must be clearly understood. It must also be clarified that management is responsible for immediate decisions affecting the going concern, a process that creates different tensions and operating challenges. However, the Committee is able to work without this ongoing business pressure, and also has the unique opportunity to jointly analyze circumstances based on proven best practices. Furthermore, derived from the successful experience of its members, the Committee is able to seek alternatives to provide additional options for management.

The responsibility of developing an ideal Committee not only lies with its members, but also with management, which must strive to ensure that the Committee is absolutely independent and possesses the high-level business capacity required to analyze recommendations, offer opinions and fulfill commitments undertaken.

Committee Purpose

The Corporate Governance Committee is primarily intended to assist the Board of Directors with the task of monitoring and evaluating the quality and integrity of accounting and business processes, while also identifying the level of compliance with the company's strategy, policies, practices and operating legal framework, together with the consistency of business objectives defined by stockholders. Furthermore, the Audit Committee must contribute business alternatives leading to successful strategies, policies and practices that, in turn, permit increased objective attainment.

As discussed in the article published by Spencer Stuart in March 2002, in Mexico, the management of board members is still at a primary-archaic phase, inasmuch as approximately 50% of companies quoted on the Stock Market pay their board members in *centenarios* (gold coins) based on meeting attendance. Although there is nothing wrong with this, the time invested by each board member must be properly remunerated, while also avoiding the development of significant economic dependencies. The following paragraphs detail some of the main personal skill requirements of the Committee Chairman and its members.

Committee Members' Personal Skills

Given the important contribution expected from Committee members, we should mention some of the elements that permit identification of people qualified to occupy this type of position. However, before reviewing the ideal profile of Committee members and the Chairman, we must first discuss two situations that help define such profiles:

First: The time required by the Chairman is very different from that of other Committee members. While the Chairman is traditionally required to make a constant effort, Committee members generally function as advisors who attend a monthly meeting lasting several hours.

Second: To enable the Committee to perform its duties, a support group reporting directly to it should be created, as this will allow members to invest a minimal amount of time while ensuring a high contribution level. Furthermore, access to and immediate application of best business practices regarding control and corporate governance, are also facilitated.

Considering the above, we can suggest that members of the Committee and, above all, its Chairman, should have the following qualities, among others:

?? Dynamism (high-level, proactive executives willing to contribute the necessary time and concentration, are necessary).
?? Openness to change and new ideas (an intelligent, knowledgeable person with a constant willingness to learn, is required)
?? The ability to listen attentively (to properly interpret stockholders' needs)
?? Fair judgment (common sense is needed to properly evaluate different situations in a timely, independent manner)
?? Communications (executive communications skills permitting the simple and efficient transmission of prevailing conditions, must be identified)
?? Discretion (the ability to diligently handle company information, while ensuring the required confidentiality)
?? Negotiations (the ability to obtain commitments and results is essential)
?? Visionary perspective (the ability to create business alternatives)
?? Knowing how to delegate and demand (leave company operation to management, while maintaining a firm attitude regarding the need to fulfill commitments)
?? A history of ethical behavior and successful experiences

Required Committee Dynamic

Formal Committee meetings are held on a monthly, bimonthly or quarterly basis, depending on company circumstances and needs. Aside from these formal meetings, the Audit Committee is expected to maintain ongoing activities; i.e., the Committee Chairman or members are expected to attend work meetings with the support team and with company directors to monitor real commitment progress.

Information Access Powers

Another vital characteristic involves full access to all business information. Without this power, Committee members are really unable to contribute to business objectives. Each company undoubtedly has information that must be handled with extreme care regarding its disclosure and the type of executives empowered to access it.

Furthermore, the company's Board of Directors must notify the entire organization that the Audit Committee and its representatives have unrestricted access to company information. This notification must also include the procedures to be followed when requesting and delivering information, as well as the related identification procedures. Extremely confidential information should only be handled through the Committee Chairman or a committee member appointed by the latter for such purpose. Furthermore, Committee representatives must incorporate different procedures into their normal practices to ensure the diligent, secure and confidential handling of all documentation and information received.

Specialist Advice and Support

Given the variety and dynamics of business circumstances and the knowledge of best business practices, the Corporate Governance – Audit Committee must seek information, consulting and activity performance alternatives that make an immediate contribution to the company, while also involving a relatively low time investment.

At times, this alternative is provided by contracting specialized support services for the Audit and Corporate Governance Committee, which permits the experience of internal personnel to be combined with the vision of external consultants who are independent of management and have immediate access to corporate governance methodologies proven in different companies worldwide.

A research report published by the "Institute of Internal Auditors" shows that the most important means of ensuring Audit Committee effectiveness is to provide their members with reference information on the real status of business processes, together with training in analysis and best practice methodologies.

Personal Courage and Energy

As discussed above, in conjunction, the underlying characteristics of the Audit Committee, such as independence, powers, technical capacity and professional experience, do not guarantee success if the final ingredient of personal energy is not present, as this implies an individual desire and commitment to make contributions to successful company performance.

Forming part of this Committee is not a simple task; on the contrary, it requires executives willing to make the utmost effort by taking advantage of all their experience and ability to find alternatives to effectively support company managemet.

Responsibilities of the Corporate Governance Committee

As a preliminary guide to duties that must be handled by the Corporate Governance Committee, below is a list of primary responsibilities:

?? Validate accounting principles, treatments and practices
?? Promote and evaluate the internal control infrastructure
?? Evaluate compliance with laws and regulations
?? Promote the sufficiency of policies and procedures
?? Ascertain, express opinions on and monitor the status of lawsuits and tax treatments applied
?? Ensure the sufficiency and high added value of the internal audit function
?? Contract and evaluate external audit services
?? Complaint and accusation reception and analysis mechanism
?? Resolution of disagreements with auditors, ensuring the effective implementation of corrective measures
?? Commitment follow-up system
?? Promote sound and efficient basic business cycle practices
?? Evaluate and promote efficient computer system operation
?? Promote self-control and generate a control and compliance culture
?? Promote penalties for noncompliance
?? Coordination and independence of audits and examiners
?? Issue a report to the Board of Directors on the business control infrastructure, compliance with accounting principles and other issues
?? Record and file the minutes of Audit Committee meetings
?? Ensure the correct application of the Code of Best Practices in the company

Corporate Governance Program

The implementation of a corporate governance program requires an ordered, clear and simple application methodology that facilitates an immediate, high-level contribution to the organization.

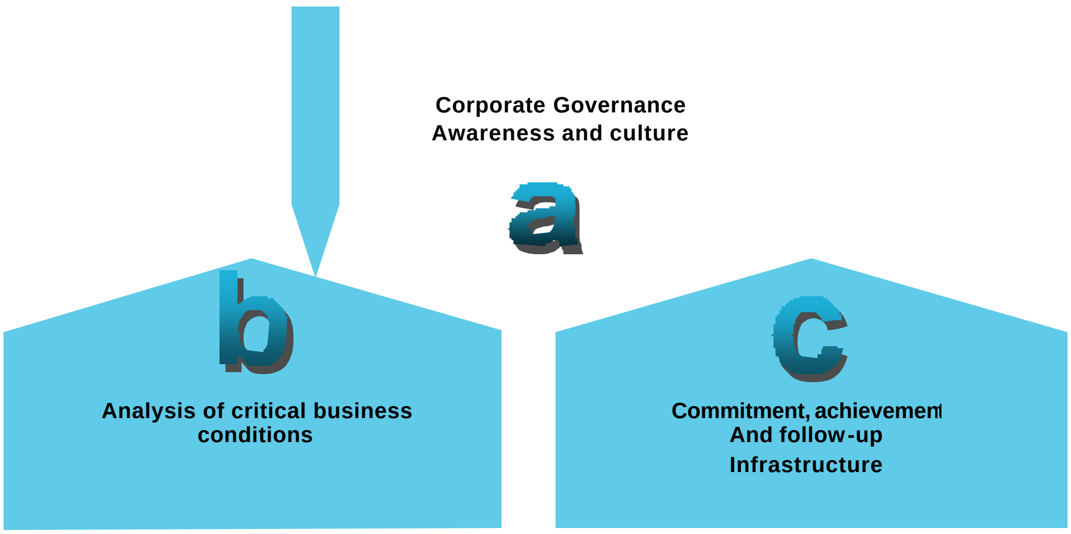
Key success factors of a Corporate Governance program include:

Key Success Factors

- ?? Independence of board members
- ?? Abilities of the Committee Chairman (the contact with the Board of Directors and its Chairman)
- ?? A working mechanism that combines members' business experience and knowledge with specialized methodologies –team of specialists– and support (analysis of critical information, modern control and management methodologies and specific best business practices approach)
- ?? Emphasis on priorities, commitments, follow-up and results

Corporate Governance Program Stages

The following graphs illustrate the three essential program stages:



Corporate Governance Awareness and Culture

This first stage means laying the foundations of a Corporate Governance culture that permits the implementation of basic premises by recognizing the organizational responsibility of each company employee and officer. This stage includes at least the following elements:

A-1
Committee integration, based on independence, business experience, a program and methodologies

A-2
Committee member awareness and updating programs. Committee creation

A-3
Preliminary diagnosis of business and control opportunities

A-4
Integration of corporate governance plan (Business and control)

A-5
Formalization of the corporate governance committee (audit) (Corporate bylaws)

A-6
Definition and implementation of management, control and audit policies

Analysis of Critical Business Conditions

The second stage of the program involves identifying, evaluating, expressing an opinion and giving follow-up to critical conditions, with particular reference to:

B-1
Business cycles (efficiencies– best practices – risks)

B-2
Main accounting treatments

B-3
Systems and contingency plans

B-4
Financial changes, trends (Covenant compliance) and high risk accounts

B-5
Complaints, fraud and client service

B-6
In tax and legal conditions

B-7
Corporate finance events (Acquisitions, sales and mergers) and clients

B-8
Regulatory compliance

Infrastructure of Commitment, Achievement and Follow-Up

The application of Corporate Governance efforts can lead to unnecessary expenses if the mechanisms required to ensure compliance with commitments involving highly effective results, an infrastructure of improvement, self-correction and permanent monitoring, are not created.

The presence of the following elements and essential Corporate Governance conditions is, of course, necessary; such elements are identified as the assurance and permanence components of the third and fourth program stages.

C-1
Follow-up system

C-2
Operating and financial indicators

C-3
Self-control agendas and alerts

C-4
Internal audit evaluation, integration and support

C-5
Integration of Controllership and Risk Management best practices

C-6
Coordination of internal control and audit entities

C-7
Report to the Board of Directors on opportunities, commitment programs, programs and achievements

Permanent Application and Program Benefits

The corporate governance program really implies a permanent activity in which the application of a three aforementioned phases is constantly repeated.

Although seeming otherwise, application of the activities established in the corporate governance program is in fact simple, provided the methodology and support of specialists with specific experience are available. Both the Committee Chairman and its members must primarily focus on contributing to the company through their business vision, while also requesting that specialists implement methodologies and best practices that are clearly applicable to the company's specific business needs.

Based on the certainty derived from personal experience, we can state that, although requiring considerable effort and commitment, the implementation of an effective Corporate Governance system does not imply an additional cost for the company. On the contrary, it represents an investment leading to savings, increased efficiency, the elimination of errors and fraud and, naturally, the possibility of maintaining a business with acceptable profit margins for a long time.

References

Contact the author for a list of references

Conflict Management and Corporate Responsibility: Opportunities and Challenges in a Period of Economic and Political Transition

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Abstract

This essay analyzes the conflict between TV-AZTECA, the second largest television network in Mexico and Televisora del Valle de Mexico (TVM) a small television company based in Mexico City, over the control of CNI Channel 40 owned by TVM. This is a long battle that has been the subject of confrontation and an arbitration process which has seen several episodes. In the last episode occurred between december 2002 and January 2003, lawyers from TV-AZTECA, commanded a hostile takeover of a transmission tower operated by CNI. During this episode, Channel 40 was off the air for one moth and was restated only after an order was issued by a federal judge. The essay explores lessons that can be learnt from this conflict. The evolution of the conflict and its connections to the political and economic transition observed in Mexico show the need to develop new corporate practices in conflict management.

Introduction

Corporate responsibility in conflictive situations is an important issue that needs to be considered to maintain a good business environment. The issue has been analized in the literature from several perspectives. For one branch of the literature the problem is how to mitigate the impacts of conflict on business operations.[1] Companies need to be aware of conflictive situations and plan accordingly. This literature however takes conflcit as given and regards business operations as "entering the conflict". But what happens when corporate practices are responsible for creating or maintaining a conflictive situation?. Corporations may be involved in such situations for different reasons and each society may produce different types of opportunities for conflicts to emerge. For a society in transition, the transformation of institutional arrangements may be one large window of opportunity for corporations to engage in conflictive situations.

The process of change observed in the political and economic realms foster changes in the expectations of economic agents involved in negotiation and conflict resolution. Some players in a conflict may wish to follow traditional approaches to conflict resolution based on previous experiences, while others may read more carefuly the uncertainty associated to the aplication of rules and procedures. Issues such as negotiation power, and the probability of forging winning coalitions may be interpreted in different, or even opposite directions by the players involved making it more difficult to reach agreement, and increasing the costs of negotiation. Often this path leads to solutions that are unsatisfactory for all the players involved. A lose-lose situation is not an imposible outcome during a period of transition. Some players may simply try to take advantage of the transition period. As shown by Dean, Bloom and Ratnikov (2003), in a society in transition, oligarchs may use hostility to consolidate their position in particular industry through the abuse of legal processes, the corruption of judges and other court officials and government officers, and the effective subversion of the legal regime.

The conflict between Tv Azteca, the second largest boadcaster in Mexico, and CNI Chennel 40, a small independent broadcaster based in Mexico City is one of the best examples of the type of controversies that may emerge in the corporate world during a period of economic and political transition. IN such environment, power, capacity and corporate practices that were useful even in recent years need to be reviewd in order to reach consensus. The battle has been conducted from a confrontational perspective focusing on winning at any costs and not looking for creating value and finding alternative options that still fulfill stakeholders´ interests (Raiffa, 1982) This is a particular case of what Dean et al. (2003) call the "Illegal conversion of minority interest to controlling interest".

The aim of this essay is to analyze the evolution of the conflict and to draw some lessons for conflict resolution in a society in transition. The argument posed here is that corporations need to take advantage of the transition and look for the right negotiation strategies that may best serve their long term goals. Corporations, is also argued, may set an example of civic mindedness that a society in transition desperately needs to maintain a good business environment and to foster social stability.

The Way to Disagreement

It took four years and six months to TV Azteca and CNI 40 to move from the announcement of the formation of a strategic alliance (Jul. 29/98) to step into violent hostility for the control of CNI 40. In the process the two companies have produced what can be seen as the best teaching case of how corporate executives may fail to serve the benefit of the shareholders and the public in general by involving their companies in controversial battles and ignoring other paths to consensus building. On October 9, the two broadcasters signed an agreement by which TV Azteca made a loan to CNI for 10 million dollars. On December 10 a new agreement gave TV Azteca programming, promoting and marketing rights over Chaneel 40. In return TV azteca paid 15 million dollars in lieu of profits for the next three years. This contract included a clause granting a buying option to TV Azteca if any of the parts cancelled the contract. This right could be exercised between november 30, 2002, and December 1 2008. On july 13, 2000, the Ministry of Transportation and Comunications (SCT) aproved the contract but established that any buying of CNI`s shares by TV Azteca should be aproved once this was about to happen. Four days later, CNI argued that SCT had not aproved the contract and removed Azteca´s signal from the screen of Channel 40.

From that day on, a battle started over who had the right interpretation of goverment and judicial rulings and, in consequence who had the right to control Channel 40. For two and a half years both companies maintained a phase of confrontation with "live" episodes of the conflict taking place from time to time in both screens. Table 1 presents a timeline of the conflict and shows how it passed trough several arbitration efforts. The problem was that each ruling was interpreted as favoring each company´s interest so the conflict escalated. In the process the conflict was took to the International Court of Arbitration (ICA), a branch of the International Chamber of Commerce. On December 20, 2002 the ICA ruled that the contracts were valid but its ruling was not clear about whether TV Azteca could excersice its buying rights, or, more precisely, if it could do that without the approval of Mexican Government. As usual, both corporations interpreted that the ICA ruling favored their interests. CNI released a news bulletin highlighting the following: a) that the contract of options – strategic alliance- is valid, b) the legal assumptions for the option to buy 51 % were not actualized and TV Azteca did not satisficed the conditions to use the option, c) TV Azteca is interpreting the ruling in a biased way to satisfy its interests.[2]

This conflictive situation reached a new level in the eraly hours of the 27 of December 2002. TV Azteca took over a transmission tower owned by CNI Channel 40. According to CNI, men in black uniforms stormed the station's transmission facilities located in Cerro del Chiquihuite before dawn. They holded channel employees for several hours and took over the channel's signal. The consequences of this episode and the way the conflict evolved for one long month is worth exploring in detail. This analysis should spread light on the failures and mistakes that need to be considered in an effort to improve conflict management and to enhance corporate responsibility.

This fast transtition from amicable negotiations searching for a common goal to violent hostility poses important questions regarding the expectations that some agents may have regarding the outcomes and evolution of negotiation processes during a particular period of time. This essay presents the argument that in this case both players, but in particular TV Azteca, made wrong assumptions about issues such as negotiation power and the economic and political environment, therefore they miscalculated the disposition of secondary players in the conflict to form a virtual coalition that favored a particular outcome.

Table 1 Timeline Of The Conflict 1998-2003	
DATE	EVENT
Jul. 29, 1998	TV Azteca and CNI Channel 40 (CNI 40) announces the formation of a "strategic alliance".
Sep. 01, 1998	Azteca 40 starts new programming
Oct. 09, 1998	Both companies sign a contract that includes programming, promotion and commercialization
Jan, 11, 1999	The agreement is announced. TV Azteca has an option to buy additional shares of Channel 40 until it has the control of the channel.
Jul. 14, 2000	The Minister of Communications and Transport (SCT) declares invalid the contract
Jul. 16, 2000	Javier Moreno Valle, (JMV) owner of CNI 40 declares on the channel´s sunday prime time news program the termination of the contract with TV Azteca
Jul. 17, 2000	TV Azteca announces that they have the intention to use the option to buy Channel 40.
Aug. 16, 2000	JMV steps down from TV Azteca´s board of directors. TV Azteca announces its intention to go to extremes in its intention to buy 51% of the shares of CNI 40.
Sep. 05, 2000	TV Azteca sues CNI 40 for 100 million dollars in damages
Mar. 14, 2001	A primary circuit judge (j-47) in Mexico city orders CH 40 to put 51 % of the shares in a trust fund so TV Azteca can have the option to buy them.
Jul. 13, 2001	CNI 40 should pay 34 million dollars to TV Azteca for damages
Dec. 20 2002	The International Court of Arbitration, (ICA) an entity of the International Chamber of Commerce releases its resolution on the case, both TV corporations argue that the resolution favors their interets.
Dec. 23, 2002	TV Azteca argues that ICC authorizes to buy 51% of CNI 40, but CNI 40, argues that ICC denies TV Azteca the right to buy its shares.
Dec. 27, 2002.	At about 2:00 AM, Tv Azteca security personnel makes a hostile takeover of CNI 40} transmisión tower in Cerro del Chiquihuite with the objective of replacing the regular programming with TV Azteca programs.
Dec. 28, 2002.	Ciro Gomez Leyva, Vicepresident of Information and co anchor of the channel´s most important news program announces his disposition to go to court and show the role of paramilitar (parapolicaco) group in the takeover of the tower. TV Azteca announces that that they will sue Ciro Gomex, for libeling
Dec, 29, 2002	CNI 40 demands the intervention of SCT to recover the intervened installations
Dec. 30, 2002	TV Azteca lawyers sue Ciro Gomez
Jan. 01, 2003	TV Azteca explores new programming for Channel 40
Jan. 02, 2003	TV Azteca publishes an add in major newspapers calling for CNI Workers to sign a contract
Jan. 03. 2003	CNI 40, workers reject to sign a contract with TV Azteca
Jan. 04, 2003	The Attorney General (PGR) issues a supoena to TV Azteca executives to clarify the intervention of Cerro del Chiquihuite CNI workers announce a public demonstration to recover the transmission tower.
Jan, 06. 2003	Several Newspapers publish an open letter to the President of Mexico signed by Ciro Gomez CNI workers march to Cerro Del ChiquihuiteInformativo 40, a news programa anchored by Sergio Sarmiento from TV Azteca begins its transmissions
Jan, 07, 2003.	Owners of both TV corporations end a meeting at dusk. A thrre days period is declared to reach agreement. Channel 40 starts transmiting color bars
Jan, 08, 2003	Mexico´s President announces that the federal governme will declare its position until after the three days period finishes.
Jan, 11, 2003	CNI workers organize a public demonstration in front the World Trade Center and distribute flyers asking citizens to support their demands
Jan, 13, 2003	TV Aztecas releases a news bulletin saying it asked Mexico City´s Attorney General (PGJDF) to invetigate JMV for fraud of 25 million dollars
Jan, 15, 2003.	The Senate calls the minister of Comunications and Transport (Pedro Cerisola) for a hearing to explin

	the situation
Jan, 19, 2003	Hundreds of persons express their support to CNI Workers in Downtown Coyoacan
Jan. 21, 2003	CNI presents a petition for protection against the government intervention of the transmission tower and the petition is received by a an administrative judge (VII)
Jan. 22, 2003	Congress votes a resolution to call the Minister of Communications for a hearing and to invite the president to restitute the signal to CNI
Jan. 24. 2003	A judge orders the government to restitute the signal to CNI 40, but SCT argues it will wait until 13:50 to take the right action.
Jan. 24. 2003	The minister of Comunication and Transportation says that the federla government will follow the ruling.
Jan. 26, 2003.	SCT ends the intervention of Channel 40 but does not give back the installations.
Jan. 27, 2003	SCT gives back the installations to CNI 40, but the company is forced to pay a bailout amount of 50 million pesos
Jan. 30, 2003	PGJDF exonarates Ciro Gomez
Feb. 01, 2003	Aprhension order aginst Moreno Valle is denied.
Feb. 05, 2003	CNI 40 announces its disposition to pay 25 million dollars to TV Azteca
Feb. 07, 2003	CNI, 40 pays the bailout ammount of 50 million pesos
Feb. 11, 2003	SCT, imposes a fine of 210 thousnad pesos for using a signal without a proper authorization.
Feb. 14, 2003	TV Azteca appeals the fine.
Feb. 20, 2003.	CNI demnds that the cancelation of the bailout for 50 million.
SOURCE: Fundación Buendía, A.C: **http://www.fundacionbuendia.org.mx/Tables/RMC/bitacora/bita62/recuadro2.html** **Proceso, http://www.proceso.com.mx**	

A Hostile Takeover

On December 26, 2002 TV Azteca decided to wait no more to take control of CNI 40. They took over by force a transmission tower owned by CNI, in Cerro del Chiquihuite in Mexico City. From that hour on and during a month the battle over channel 40 went "live" not only in the both brodcasters screens but almost in any newsoutlet –printed or electronic- that was availbale. While most news sources in Mexico and in other countries were busy reporting the case emphasizing the force and illegality of the takeover, TV Azteca launched a campaign arguing that the action was justified according to the ruling of the International Court of Arbitration. While both players lost in the process, the loses were bigger for TV Azteca.

TV Azteca Loses Public Opinion

In retrospect, it is fair to say that the hostile or violent takeover conducted by TV Azteca produced an unexpected outcome for this corporation. Their efforts to convince the public that this action was right, fair and legally grounded felt into a heated public arena that did not favored its cause.

Almost all observers regarded the takeover conducted by TV Azteca as the worst example of illegal use of force to take advantage of a week adversary. Several TV news sources including Azteca´s bigger rival Televisa, reported how armed guards in ski masks from TV Azteca took the station's studio and held staff for several hours. Ciro Gomez Leyva, CNI´s major news anchor claimed that this could have been the media world's most hostile takeover. In a small dispatch that he posted to the group Democracy Now, he quoted CNI´s news editor Manuel Feregrino saying that "They retained the IDs of our staff, their addresses were taken, and they were told that their families could be in danger," .[3]

On December 29, the BBC posted in its webpage a report of the takeover and a summary of the conflict (Fig. 1). In this report the BBC was clearly critical to TV Azteca. It echoed other voices and described the event as one that "could be the most hostile takeover ever" it gave space to the allegations that it used "armed men in ski masks". For the BBC reporters this was case of abusive force used by a giant against a small player. TV Azteca was reported as "the world´s second biggest spanish-language programme-maker".

Amerricas.Org, a branch of the Resource Center of the Americas, an international organization focused on the defense of human rights, reported the case on its webpage with the title "Guards take over TV station"[4]. In this report, drawn from Mexico City´s major newspaper *La Jornada*, CNI was portrayed as an independent TV station while TV Azteca was protrayed as one of Mexico´s two TV Monopolies.

By January 6, most important news media oulets in Mexico City had covered the conflict and the prevailing spirit of the coverage was one of criticism to TV Azteca and to the lack of action by the federal government. CNI workers and executives were clearly more succesful in gaining the battle for the public opinion. Javier Moreno Valle, his lawyers and the most popular faces on Chanel 40´s screen were at the front of a public demonstration conducted by CNI workers and executives. Protesters marched to Cerro del Chiquihuite to demand that instalations should be returned to its owner. As expected this action had a broad coverage. Even as they were in their way to Cerro del Chiquihuite Reforma, an influential newspaper ran an article in their business section under the title "Arrancan Marcha Empleados de CNI"[5]. Simultaneusly , the business section ran an article on the same topic that emphasized the relevance of the protest within the conflcit. "The conflcit wil take new dimensions", wrote Abel Barajas and Ernesto Nuñez, authors of the article[6].

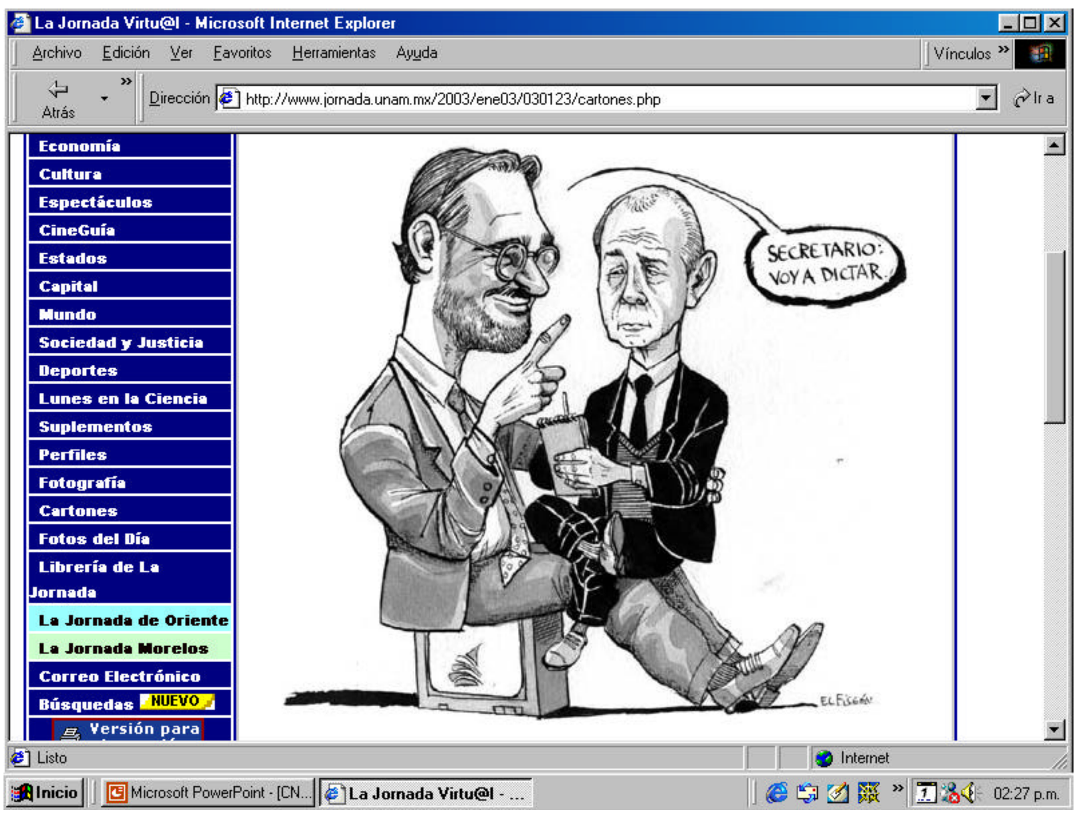
FIG. 1. MEDIA COVERAGE DID NOT FAVOR TV AZTECA

TV Azteca Loses Political Support

Along with the lost of public opinion, TV Azteca also lost political support. Little by little, key political players took distance from the takeover conducted by the television company. Some were seriously critical of the postion assumed by TV Azteca. Senator Javier Corral (PAN), Chief of the Communications and Transportation Committee, played an important role in criticizing the act and in creating a colition to put pressure in the executive to intervene and return the transmission tower to CNI. On Dec, 31, he wrote an op ed column in EL UNIVERSAL[7], one of Mexico City´s most influencial newspapers titled "TV AZTECA: Calculating Power". For Senator Corral, Azteca´s violent act had not comparison world wide, and it could only be compared to acts conducted by guerrilla movements in Central and South America. In his words this was "one of the most serious challenges launched against the democratic change in Mexico, and one of the most serious provocations to legality". Thus, he argued, one may assume that in conducting this act, TV Azteca is calculating how much power it has over the formal institutions of the state and over the government of Mexico. For Senator Corral this act was only one in a chain of abusive behavior that TV Azteca had developed in the past against the goverment which included having a black list of political actors to put pressure on them and the censorship that they have excerscsed even to the President of Mexico. Fig. 2, shows how newspapers were very critical in the way TV Azteca was trying to push a solution favoring its interests by lobbyng the presidency of Mexico.

On January 22, the Permanent Commission of Congress passed, by unanimity, an agreement to demand the executive branch the inmediate devolution of the transmission equipment to CNI and to call the minister of the interior (Secretaria de *Gobernacion*) for a hearing. In Mexico, this minister has the capacity to oversee TV concesions. In their agreement congresspeople argued that TV Azteca had acted illegally when it took control of Cerro del Chiquihuite[8]. Representatives from the three largest political parties, demanded both television

FIGURE 2. TV AZTECA MISCALCULATES POLITICAL SUPPORT



companies to take back their conflcit to court. Senator Diego Fernandez de Cevallos, leader of PAN senators (Partido de Accion Nacional) urged the federal government to find a solution to this conflict. After a judge ordered that the government should end the intervention, Senator Fernadez was quoted by several newsoulets saying that the first thing the government should do was to "take no delay in restituting the signal from Cerro del Chiquihuite to its legal concesionary, Channel 40"[9].

TV Azteca Loses in Court

On the 24th of January, the Judge for administrative affairs Luz Maria Diáz Barriga gave a provisional judicial provision (amparo) to CNI Channel 40 and ordered to cancel the intervention (aseguramiento) of Cerro del Chiquihuite and to restablish Channel 40´s signal. The federal government claimed that it did not have to return the instalalations to CNI since the ruling did not establish to whom they should be given back. In an example of the mood that prevailed in the federal government, Pedro Cerisola, minister of comunications declared during an interview while touring an industrial park that he ignored the terms of the provision and what aims it was trying to pursue but regardless of what was on it, the federal government will follow the ruling of judge Diaz Barriga[10].

For TV Azteca there was still hope. Even when it was clear from the events of the past two weeks that TV Azteca was losing the battle, their lawyers were still claiming the right to the signal. Meanwhile Reynaldo Reyes Rosas, a federal judge acused nine TV Azteca employees who were involved in the takeover of the instalations of CNI for the crime of stealing television space[11]. By January 7, the screen of Chaneel 40 was transmiting color bars.

On January 27, after a federal criminal judge refused to rule on which of the two tv companies was entitled to get back the instalations after they were intervened by the government, the Ministry of Comunications and Transportation returned the transmission tower to CNI. The judge ruling established that this was not a criminal issue but an administrative one[12].

Dealing with Conflict and Corporate Responsibility

An issue that needs to be analyzed on the light of the episodes of conflict between TV Azteca and Channel 40 is to what extent corporate managers should be held responsible for bad conflict management practices.

This includs hostility in takeover attempts such as the one conducted by TV Azteca over more than two years. In light of the public debate that emerged in the aftermath of the assault to Cerro del Chiquihuite, it is clear that there are at least four areas in which corporate responsibility is a major concern when dealing with conflicts in a society in transition: this areas are, a) the impact on the credibility of market rules, b) the impact of hostile tactics on peoples perception of the legal system, c) the impact of hostility on a company´s employees reputation and morale, and d) the impacts of hostility on the company´s financial situation.

Impacts on the Credibility of Market Rules

This episode of the conflict between TV Azteca and CNI had, and still has the potential of affecting Mexico´s credibility. If this type of behavior is tolerated, investors who could see their investments unprotected by the law and from hostile competition. Using this case as en example, *Business Edge,* a web based news report wrote in its edition of January 9, 2003. “If you thought competition was tough in Canada , you better think twice about expanding to Mexico . Federal prosecutors there are investigating claims a rival television station took over another channel using private armed guards wearing ski masks”[13].

Impacts on the Legal System

The assault conducted by TV Azteca was quickly framed by media analysts and intellectuals as a challenge to the rule of law in Mexico and as an example of the need to change the relationship between government and the media. As pointed out by Pou Gimenez, (2003). “The tardy, incorrect, and confused reaction of the government planted embarrassing suspicions of governmental complicity with the invading television station, but above all else reinforced the image of a government weighed-down by a simple incapacity to react and with a instinctual tendency, once again, to entrust dispute resolution to negotiation processes, even in cases that do not have anything to do with freedom of expression or demands of social justice”[14].

Impacts on Employees Reputation and Morale

By opting to pursue a confrontational strategy a corporation is not only putting in jeopardy its prestige, image and opportunities to grow, it is also endangering its employees´ reputation and morale. The hostile takeover conducted by TV Azteca demanded workers in both corporations to assume a position on an issue that was beyond their control but still had to be decided putting at risk their future and reputation. On CNI 40 side, employees were presented with the dilemma of choosing whether to sign a contract with TV Azteca or being loyal to their current employer. Under the conditions of the debate that petition could be regarded as pure harassment for which there is no easy way out or legal defense. Most employees decided to stay with TV Azteca, but the few that parted ranks with CNI, were quickly portrayed as defectors who had no value for CNI anyway. Azteca employees did not have an easier situation. Those involved in the assault had the worst part because they were indicted with criminal charges. But they were not the only ones who sought their careers facing a major hurdle. Sergio Sarmiento, an influential news director in Azteca gave its face to a short-lived news program at CNI 40. This act was regarded by other journalist as an immoral act that was tainting Sarmiento´s prestige. These are situations that could be avoided using a different negotiation strategy that seeks beyond the simple goal of winning.

Impacts on Corporate Finance

For TV Azteca and CNI the conflict has had huge costs and they may be even larger. These costs include not only those associated to the legal battle, but also the impacts on shareholders perceptions and advertizers. There are certainly big gains to be obtained by each company, should they get a favorable outcome. While such outcome can only be assessed in the long run, there are costs and risks to be faced in the short run. In the mist of the battle for the control of Cerro del Chiquihuite, IXE Bank analysts reported that in an escenario of an extended conflict Azteca´s image among shareholders would face serious damage[15] This hipothesis, not confirmed yet, seemd more likely two month later. On March 28, Standard & Poor"s, anounced that it was reducing the credit ratings for Azteca Holdings on the basis of its debt problems and the dificulties to face its obligations. 6 days later, Moodys anounced that it may follow S&P, and reduce its ratings for the corporation[16]. While S&P based its decision on the difficulties faced by Azteca Holdings to finish an exhange offer which was considered disstresed and not precisely because of the impacts of Aztecas legal battles, the conection between the two cannot be discarded since it also confirmed that TV azteca shares had also a negative perspective[17].

Beyond the costs associated to bad image, the conflict had costs for both corporations. Just the ICC arbitration process had a total cost of 370,000 USD, paid in half for each part (See Table 2). Other legal costs are not disclosed but both corporations have maintained a team of highly qualified lawyers for more than two years.

Table 2

ICC Arbitration Costs

ITEM	COST IN USD
Administrative costs	41,600
President of tribunal	102,640
2 Co-arbiters	153,960
Mision of tribunal	17,800
TOTAL COST	370,000
PAID BY EACH PART	185,000

SOURCE: ICC International Court of Arbitration. Final Resolution. Version consulted in:

http://www.tvazteca.com/hechos/archivos/2002/12/68753.shtml

NOTE: The final ICC Ruling asked the sued player to pay 70 % and the suer 30 %: see: http://www.cnienlinea.com.mx/boletines/resolutivo%20paris.html

Lessons for Conflict Resolution: An Opportunity for Changing Corporate Practices

What are the lessons of the conflict between TV Azteca and CNI 40 for conflict resolution and conflict management? Does this case show the need for better conflict management practices at the corporate level? Do conflicts between private corporations have any implications for the society at large? Does a transition represent an opportunity for changing corporate practices in conflict management? These are questions that need to be addressed by decision makers in both the private and the public realm. From the academic perspective the case shows how a transition represents a challenge for corporate executives involve in conflict management. For one thing, this case shows the disadvantages of miscalculating power and negotiation capacity and the importance of a careful analysis of new rules and patterns of relationships that emerge during a period of political and economic transition

Some of the key mistakes that took place during the process that clearly demand changes in strategy include the following:

- ?? CNI 40 signed a contract from a weak position and gave almost any power of decision making on key issues such as programming, without enough contingency clauses that could be renegotiated with the aim to have a better contract under certain conditions.
- ?? Both corporations sought the backing of the federal government, which was granted without a careful revision of the existing legislation. The result of this was a heated debate over whether or not the contracts were approved. As a result, it was possible to assume that the backing of the contract was sufficient as long as none of the parts decided to move towards confrontation. Thus when CNI 40 estimated that TV Azteca would not follow the contract as expected (programming or marketing), decided to interpret that the government had not approved the contract and cancelled the terms of the agreement that gave rights of programming to TV Azteca, and took control of he signal of channel 40.
- ?? That decision induced new rounds of confrontation and the case was taken to arbitration courts whose rulings were regarded by both corporations as favorable to their interests. When TV Azteca decided to takeover the installations of CNI based its decision in overestimation of its power and influence. As it was proven by subsequent judicial rulings, TV Azteca violated Mexican legislation , perhaps expecting the support of the executive branch of the federal government, which, in their plans, would put an end to the controversy.
- ?? By taking this path, TV Azteca ignored several changes that were taking place in the last years in the public and economic spheres. Among others, it ignored the new role that mass media and newspapers were playing in shaping public opinion, and more specifically how this was occurring in a context of a democratic society. In retrospect, it could be said that this was a huge mistake not only because most news outlets dedicated a lot of space to the case in question, but most important, because a large proportion of the coverage was very critical of TV Azteca´s arbitrary decision.
- ?? Tv Azteca decided to ignore that a more critical public opinion was already formed. Thus, it launched a campaign that in vain tried to convince the public opinion that the key issue was whether or not there is respect for legal contracts in Mexico. But public opinion interpreted the case in a broader sense and regarded Azteca´s action as a challenge to the most basic tenets of the legal system in general.
- ?? But most importantly, TV Azteca blatantly ignored the changes observed in the relationship of the judicial, the legislative and the executive branches of the federal government. This could be easily regarded as the worst calculation made by TV Azteca´s corportate executives and lawyers. The result was far from what they expected. Congress put a lot of pressure on the executive to intervene and restore the respect for Mexican law. In the same vein, judges ordered the executive to intervene and to return the situation where it was until the day before the assault. Thus the executive was virtually forced to return the installations to CNI 40. When it did so, TV Azteca argued that CNI 40 had incurred in unlawful behavior with the court system and decided to launch a campaign against specific political and judicial targets.
- ?? At the end, the executive returned the conflict to its situation of December 2002. This decision put both corporations back to the negotiation table. To take advantage of the new opportunity, CNI 40 offered some choices to Azteca but they all were rejected. Salinas Pliego, owner of TV Azteca declared to Expansion, that despite of the lessons he thought that Azteca was doing the right thing and defended the corporation´s controversial attitude.

In sum, corporate executives have missed the opportunities for consensus building created by the process of economic and political transition which has resulted in a failure to forge stronger corporations and to develop negotiation skills to cope with the new political and economic environment.

Conclusion

From the theoretical perspective, this case is clearly an example in which a lose-lose situation prevails over any other option that could be considered. Corporate executives involved in the negotiations between CNI 40 and TV Azteca clearly lost the opportunity of addressing the situation from value-creating approach and come up with solutions that could strengthen their position in the market. The case also shows that in a society in transition, corporate responsibility in conflict management has a broader impact on society. Hostile takeovers such as the one attempted by TV Azteca over CNI constitute bad corporate practices that may endanger the future of the Mexican economy. The public outcry for respect of the legal system is a logical outcome in a society that desperately needs to put in place a legal system that makes the country attractive to investors.

Drawing on the lessons of this case, it is possible to develop a long lists of recommendations for corporations and lawyers that may wish to change their approach to conflict resolution. For lack of space I want to stress that, to cope with the new challenges posed by the process of economic and political transition in Mexico, corporations seeking to address conflict resolution assuming full responsibility with their stakeholders and the public at large, may want to focus their work on the following elements: capacity building in both conflict assessment and negotiation, changing negotiation culture to focus in the creation of value, careful evaluation of negotiation capacity, power and the possibilities for coalition building with players that may no be directly involved in the conflict but may influence the outcome of a negotiation process by simply expressing their point of view on the situation; and last, but not least, a careful evaluation of the experience of negotiator and lawyers. In the face of a new conflict, corporations should seek to adopt an agency form with their negotiations that is appropriate for the situation since this has an influence the negotiators´ effectiveness (Salacuse, 1999) and in particular they should evaluate negotiators´ capacities to deal with uncertainty, which seems to be a central feature of the context for conflict resolution in a period of transition.

The fact that two important corporations have been able to escalate a controversy to the level observed in this case reveals the need to strengthen the legal system to institutionalize alternative options for conflict resolution. Beyond the legal debate, this case also shows that corporations, in particular those with a large capacity to shape public opinion such as TV Companies, need to assume their responsibility in the public domain to show entrepreneurial civic mindedness when facing a conflict situation. Bad civism is a path not worth pursuing for corporations, not only because is not a good strategy for conflict resolution under a period of transition, but also, and this is perhaps more important, because in such an environment it may poison the basic institutions of society which are key to achieve economic growth and social development.

References

Contact the Author for a list of references.

End Notes

[1] See, Anderson and Zanbliet (2001).
[2] See: CNI, COMUNICADO DE PRENSA, http://www.cnienlinea.com.mx/boletines/resolutivo%20paris.html
[3] See: Hostile Takeover in Mexico City: armed guards from television giant takeover independent tv station. In http://archive.webactive.com/pacifica/demnow/dn20030101.html.
[4] http://www.americas.org/news/nir/20030110_guards_take_over_tv_station.asp
[5] http://www.reforma.com/espectaculos/articulo/258641
[6] See Reforma, Jan. 6. 2003. “Llevan a la calle conflcito por canal 40”, in http://www.reforma.com/nacional/articulo/258547/
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Whither Corporate Social Responsibility?

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Abstract

There are growing demands that the corporate world act with greater social and environmental responsibility. This paper examines these demands and their likely impact on corporate behavior, beginning with a definition of the concept of 'corporate social responsibility' and briefly commenting on the equivocal status of the concept within the business community. An attempt is then made to highlight the core ideas of the concept while also indicating its broad scope. The author summarizes the publicly stated attitudes of a number of prominent corporations followed by a description of some of the mechanisms which have been developed in recent years to assess corporate performance in this regard. Brief description and discussion of these mechanisms reveals the still-fuzzy nature of the 'corporate social responsibility' concept and leads naturally into consideration of the ideas of those who criticize the concept. Finally, the paper seeks to reach a balanced judgement about what society may reasonably expect of business and, more particularly, how business might most sensibly respond to the growing community pressure to be 'socially responsible'.

Concept and Issues

A growing number of voices in contemporary society are calling on business, especially larger corporate enterprises, to contribute more to general public and social welfare. While these calls are varied and some are imprecise, the basic idea is that individuals as citizens, consumers and employees, want a commitment from business to a broad notion of *social responsibility*. This is a view which is increasingly heard. Proponents of the idea demand that business pay more attention to the needs of the environment, the community, the workplace, and much, much more. Such thinking stretches the established, legal responsibilities of business into new areas and proponents demand that business accept costs and responsibilities which may be remote from their commercial focus and from which there may not be any identifiable return in revenue. So, *corporate social responsibility*, hereafter *CSR,* is a big and complex issue. Not surprisingly, it is argued over and not all accept it as legitimate. Nonetheless, it is increasingly at the forefront of senior managers' minds; particularly those with direct responsibility for risk management.

The traditional, narrow, attitude towards the non-economic responsibilities of business is commonly represented by quoting Nobel prize-winning economist, Milton Friedman. In an article he once wrote for the New York Times' magazine section [6] he stated in crystal clear terms the view that:

> "The business of business is to maximise profits, to earn a good return on capital invested and to be a good corporate citizen obeying the law – no more and no less. To go further in a deliberate fashion is to exceed the mandate of business. It is to make what amounts to an ideological stand with someone else's money and possibly to engage in activities with which many stockholders would not agree."

There is however a wider, somewhat more contemporary, different view. This is that a company, which in law after all is a legal person, can legitimately be regarded as analogous to a real person, so that concepts of responsibility may be applied to both; in this way a company can be considered a *morally* responsible entity. In the words of another prominent economics professor, Kenneth Andrews [1], corporate social responsibility may then be defined as:

> "Sensibility to the social costs of economic activity and to the opportunity to focus corporate power on objectives that are possible but sometimes less economically attractive than socially desirable."

This latter statement makes explicit the core issue in the contemporary debate about corporate social responsibility and its legitimacy. The key question is whether, when there is *no* legal or financial reason, companies should nonetheless address social and environmental issues? This question can arise in the context of basic human rights as well as with regard to child labour, pollution standards, sustainable resource exploitation, and so on. In fact it is a very many-sided question. Research reported by staff of McKinsey's [4], has suggested that ethical and social responsibility issues may clash with emerging business opportunities in at least four growing categories of commercial activity. These are: the exploitation of some new technologies, such as GM foods; the movement of activities from the public to the private sector, like power and water supply; entry into third world markets, as with subsidised foodstuffs from the EU in Africa; and the exploitation of legally contestable markets, such as tobacco, alcohol, gambling and sex.

Business Perspectives

CSR poses a stark question for the business community: "When there is no clear financial reason, after all contractual and legal obligations are met, *should* companies still address wider social and environmental issues?" Big business is already familiar with the notion of the 'Triple Bottom Line', comprising a balance sheet of environmental and social consequences of business operations in addition to the necessary financial outcome [3].. However CSR seeks to extend this whole-of-business approach and to make it obligatory for all. In fact there have already been moves in some jurisdictions to *require* corporations to produce social and environmental reviews as part of their annual reports. France, for example, already has legislation requiring listed companies to make such information available to investors and a British company law review has similarly recommended that public corporations be required to produce social and environmental reviews as part of their annual reports [17]. Moreover, in 2001, 45% of the largest global companies published Triple Bottom Line reports voluntarily and 72% of top Japanese firms produced sustainability reports [11]. Similarly, since 2000, UK pension funds have been required to publish the percentage of their portfolios placed in 'socially responsible' investments.

Yet not all are convinced this is desirable. Some think it completely misguided, noting that many companies are ill-equipped to anticipate the less direct social consequences of their actions [19]. In any case, if society wishes to focus on social goals, rather than economic ones, it is legitimate to ask why this should become the responsibility of the private corporate sector, rather than the public and accountable political process.

Given the contested legitimacy of CSR and disparate approaches to the issue in different jurisdictions, it makes practical sense to take note of specific corporate responses. This is especially the case among larger, more globalised companies. One example is offered by Sweden's *'IKEA'*, the world's largest retailer of furniture and home furnishings, a company with an annual revenue in excess of US$5 billion [10]. This is a highly individualistic company which actively protects its entrepreneurial and innovative traditions. On its own initiative, it developed what it terms its 'Natural Step' framework to enable it to assess the ecological and social sustainability of its commercial activity. Sustainability is both commercially important and environmentally relevant in an industry based largely on timber. Another case is offered by the world's fourth largest oil group, '*TotalFinaElf*' [7]. In recent years this company has come in for a barrage of public criticism, from NGO's, safety regulators and some shareholders, for maintaining links with arguably unsavoury regimes in such countries as Burma, Iran, Iraq and Libya. Indeed, revelations at a trial involving former employees suggested that bribery was a core competence of the company [2]. In response, in 2003, the company commissed an independent review of its safety and ethical standards by 'GoodCorporation'. In due course it hopes to apply the findings of this review in a manner which will help it shed its controversial image. More generally, the Ashridge Centre for Business and Society surveyed Fortune 500 companies in 2000 [12]. Although only 52 of the 500 companies responded, 36% of those which did indicated that human rights issues had caused them to abandon a proposed investment project and 19% of them had actually withdrawn from existing operations in a country on account of human rights issues. One publicly documented case of such disinvestment is that of '*PepsiCo'*, which left Burma in 1997 following intense public pressure from human rights and student groups.

The latter example, among others, illustrates a growing corporate sensitivity to social and environmental issues. Of course, the response may well have as much to do with self-interest as it does with morality. One factor which is certainly present in the corporate mind is a recognition that social and environmental considerations *need* to be addressed when they are likely to impact on corporate reputation and profitability. A different factor, sometimes present, is recognition that CSR aids employee attraction and motivation. Another factor is the potential contribution of CSR activities in the management of risk.

For all of these reasons, many big companies are moving beyond minimal legal compliance with regulation and willingly embracing a deeper, more active, involvement in the wider community. To the extent that they do so, this implies acceptance of a much broader concept of who and what constitutes a stakeholder, plus at least some degree of corporate social responsibility to the broader citizenry.

In the aftermath of the demise of Arthur Andersen, no large corporation today is unaware of the frailty of corporate reputation. As the Andersen saga demonstrated with brutal clarity, it need take only one false step to destroy a hallowed reputation. More generally, a single negative story can strip billions of dollars from a company's share value in minutes, hurting shareholders and employees alike. So, as a recent Director-General of the World Trade Organisation has written [13]:

> "The challenge for companies is to leverage the power of their brands for socially positive outcomes without damaging their profitability, and in doing so overcome some of the prevailing distrust of global business."

One global company which ignored the risks was '*Bayer'* before 2001. Although their pharmaceutical product 'Baycol', 'Lipobay' in the USA, was first associated with unexpected deaths in 1998, it was only in 2001, after the Federal German Institute for Medication and Medicinal Products had determined that the product caused 'undesirable medication effects', that the company took the product off the market. When this was finally done, the company share value fell approximately €6 billion in just two days [20].

Indices and Measurement

Efforts have been made over recent years to measure *the level* of CSR displayed by corporations. Not surprisingly, this has proved difficult. There have also been efforts to identify the number of companies which have accepted *the principle* of CSR. Indeed, there are already at least four international Corporate Social Responsibility frameworks which are reasonably well known, from which companies can choose. These frameworks are all available in user-friendly form, online, free of charge:

?? UN's Global Compact
?? AccountAbility 1000
?? Social Accountability 8000
?? Global Reporting Initiative (GRI)

The last of these was launched in New York as recently as April 2002 but it already has a faster take-up rate than the others. There is a permanent GRI secretariat based in Amsterdam and about 150 companies have already published annual reports based on its *voluntary* guidelines [5]. In addition to the above frameworks, the UN Environment Programme has jointly launched publication of a 'SustainAbility' league table which attempts to show how effective companies are proving to be in meeting CSR objectives. Some believe this SustainAbility table illustrates emerging best practice in reporting on the Triple Bottom Line. However, at this stage, few companies are linking sustainability directly with governance or with brand management and few observers would claim that environmental reporting is yet firmly established in the corporate world.

The 'Global Compact' was launched by UN Secretary-General, Koffi Annan, in 1999. It promotes nine business principles, covering human rights, labour standards and environment, with considerable emphasis on labour practices. It is very broad in scope and does not lend itself to easy measurement of progress. 'AccountAbility 1000', in contrast, comes out of the non-government Institute of Social and Ethical Accountability in London. In another contrast, this does offer a standard for measuring and reporting 'ethical behaviour' in business. Its designers hope, thereby, both to improve ethical performance and to be able to judge the validity of company's ethical claims. The goal is to help business define targets, measure progress towards the targets, audit and report performance, and establish feedback mechanisms. The standard is designed for both internal and external audit procedures and to be applied by businesses of any size. The third framework, 'Social Accountability 8000', is a voluntary, universal, standard for companies interested in auditing and certifying their labour practices together with those of their suppliers and vendors. Like the UN 'Global Compact', it highlights nine key areas for assessment, but unlike the

Compact it seeks to measure performance in these areas. This is despite the inclusion of notoriously hard-to-measure dimensions like 'discipline' and 'discrimination'. 'The 'Global Reporting Initiative', which is already more popular than the others, is developing a corporate disclosure framework which businesses can use to *fully* report on their economic, environmental and social performance. The reporting guidelines are of course entirely voluntary. However the GRI is currently leading debate on issues such as the triple bottom line in accounting and is acknowledged by many CSR enthusiasts as the leading initiative of its kind.

Step Forward or Red Tape?

In most major jurisdictions attempts are already underway to measure CSR. In Australia, for example, there is the Good Reputation Guide, or RepuTex. This is compiled by a private organisation, with respected university support. It seeks to rank the CSR of Australia's top 100 companies on an annual basis. The detailed annual rating is then sold to companies for A$25,000. However this ranking mechanism is not without serious criticism. Companies that respond to the survey and complete it carefully, tend to score well, while companies which omit answers to some questions or do not respond at all, attract zeros. This, of course, risks a situation in which respondent companies score highly while those which do not complete the survey, do badly. This is seriously misleading. It is hardly the case that a company is 'bad' in terms of CSR just because it chooses not to participate in the survey! [8]. A more widely known and probably more soundly based corporate ranking of this kind is the 'Social and Environmental Ranking' of SustainAbility.

The issue of measurement is a complex one. In the first place, *no* universally agreed CSR standards have yet emerged. In any case, it is not yet known to what extent it makes practical sense to apply common standards across all sectors of business. At the same time, in principle, measurement seems the only reasonable way to monitor progress.

The next question which often arises, is whether moves towards corporate social responsibility should remain largely voluntary, as at present, or be strengthened by new legislative requirements. The question is raised here because we have already noted some piecemeal moves towards the regulation of CSR and there seems to be something of a trend in this direction, at least in Europe. However the consequences of CSR regulation are not necessarily obvious, nor is its desirability established.

The Proper Place of CSR?

To date, CSR thinking has only had real impact on larger companies, which is probably what we should expect. It is the larger companies which are most in the public eye and these are the ones responsible for most of the more prominent developments. Among these large companies, however, the impact of CSR thinking is often considerable. Many of them accept, albeit sometimes reluctantly, that the need for enhanced CSR is simply a fact of modern, corporate life. This view is particularly prevalent in those sectors of business, like mining and pharmaceuticals, where there have been some spectacular corporate misjudgments in recent years. The cost, in both money and reputation, of the former BHP's environmental degradation caused by its Ok Tedi mine in PNG, is but one well publicised example. The case of Bayer, mentioned above, is another. Some, more and more, bigger companies today are accepting responsibilities outside their sphere of direct commercial interest, in the non-business world; at least, in the communities in which they operate and are exposed to public view. Some evidence of this comes from a survey of 50 CEOs from 16 countries, undertaken for the World Economic Forum in 2002. This identified four frequently cited reasons used by big business to justify what they chose to call 'good corporate citizenship'. These were: to enhance their corporate and brand reputation; to attract good employees; to protect their license to operate; and to help compete for market position (Taylor, 2003). This survey also identified that the relevant decisions on such matters were nearly always taken in one of the following three ways: by a subcommittee of the board; by a committee of senior executives; or by following external advice. A comparable Australian study of CEOs [18], identified that:

> "Often CSR is manifested in partnerships and agreements with community organisations, in recognition that businesses have social, cultural and environmental responsibilities to communities – *alongside* (my italics) the firm's financial responsibilities to shareholders."

At first sight this may all seem too good to be true. On the other hand, it may be supporting evidence for the views of well-known Harvard economist, Michael Porter [14]. Porter believes CSR can increase rather than decrease corporate returns. Like both Porter and the World Economic Forum respondents, Richard Lambert, editor of the Financial Times from 1991 to 2001, suggests there may be three reasons for this:

The first is to enhance and avoid damage to reputation; especially with consumer products;
The second is to help recruit and retain the best employees;
The third is to enhance the surrounding business environment.

There is further evidence of the growing acceptance of CSR. In March 2003, some 120 companies voluntarily participated in the first index of 'Corporate Responsibility' of the 'Business in the Community' organisation. This is an index which defines responsible business practice and enables companies to assess and compare how they integrate responsible practices across their organisations in four key areas. These are: environment, marketplace, workplace, and community. The index was developed and tested with input from 80 companies.

A comparable development has occurred within the financial sector under the auspices of the World Bank's International Finance Corporation. Here, the Heads of 'project finance' and 'risk management' have collaborated with ABN Amro, Barclays, Citibank and WestLB, to adopt a sector-specific set of social and environmental rules known as the "Equator Principles" [16]. These aim for sustainable development and include guidelines on issues ranging from environmental assessment and natural habitats to indigenous peoples and child and forced labour.

Such developments reflects increasing sensitivity to the risk to reputation of participating in controversial transactions; in both the private sector and in international organisations, For example, both Citibank and JP Morgan Chase have recently been publicly challenged for providing services which helped *'Enron'* inflate its reported earnings. John Ruggie, the Director of the Harvard Center for Business and Government [15], argues that many companies fail to grasp the extent to which they are at the receiving end of a sharp increase in social expectations about the role of the corporation in society. He believes that this is not just about philanthropy or even ethics, but about many-sided social accountability to society at large. He adds that "we live in a world of proliferating problems without passports" and that, unlike national governments, large corporations have demonstrable global reach and can make decisions and act faster than governments or their agencies. In this view, we should recognise that large corporations are more than mere economic actors on the world stage and are powerful social actors in today's globalising world. Ruggie argues that these realities are fundamental to an understanding of the *emerging* nature of corporate responsibility.

Yet we cannot forget that CSR approval remains far from universal in the business community. Support, moreover, is largely confined to the big end of town. In addition, the drift towards increased acceptance of CSR remains without any generally agreed intellectual underpinning. As indicated at the start of this paper, *informed* opinion remains divided.

A MORI investigation of European public opinion on CSR, however, has yielded some very clear indications of 'majority' *popular* opinion. A clear majority in each of twelve European countries surveyed claimed to regard company commitment to social responsibility as 'important'. While this is not surprising, 70% of European consumers also claimed that such company attitudes influenced their purchase choices and some 20% of them claimed a willingness to pay more for products which are socially and environmentally responsible. Indeed, in Switzerland, Spain and the Netherlands, no less than 66% of respondents thought large companies should actively address social issues.

On the other side of the debate, the most telling argument is probably the philosophical one that social goals are more *properly* pursued through open and legitimate political process, rather than through private, commercial agents which, ultimately, may lie beyond popular control through the democratic process. This argument has been clearly expressed by one leading economic journalist in the following terms [9]:

"If we want to pursue social goals, the right way is openly, through the political process where the pros and cons can be argued out explicitly. CSR will either achieve little or do harm. Which one it will be, I do not know. But I do know the right response is one of profound scepticism."

In this view [21], if CSR deflects business from its primary goal of profit, it is unlikely to prove successful for long. In any case, other things being equal, less profit is likely to mean fewer jobs and lower tax revenues. So, effectively, the price of corporate social responsibility comes from *both* profit and tax paid. While it is true that business *can* add to social welfare by prompt and effective community action, it is not at all obvious *to what extent* business should be expected to do so. Further, there is unlikely to be easy agreement on this point.

Conclusion

There is obviously still plenty of room for debate about CSR. A spread of opinion is anyway evident on most aspects of the issue, including its desirable scope, how best to encourage it, how best to measure it, and whether to keep it entirely voluntary or introduce elements of compulsion. It is likely that all these questions will be the subject of increasing attention in the near future.

This observer's judgement is that if CSR risks deflecting business from its primary goal of profit, common sense suggests that it is unlikely to be very successful. Ultimately, profit has to come first; without it, there can be no company. At the same time, business *undoubtedly has the capacity to* add to social well-being, in a community sense which goes beyond economic activities. There are myriad examples of this, large and small, ranging from Quaker entrepreneur-philanthropists in eighteenth and nineteenth century England to the Tata family businesses in contemporary India. It is worth noting explicitly, however, that the cost of CSR activity must obviously come from company revenue. This means, in reality, that CSR expenditures must come at the expense of something else, presumably profit and tax. In addition, the acceptance of costly burdens by profit-seeking companies cannot easily be imposed on the ill-qualified or the unwilling. This is the risk if CSR is imposed by legislative compulsion. So this observer judges that a combination of moral suasion and market pressure is much more likely to prove effective. In this view, any attempt to spread social burdens on business through regulation is far more likely to be counterproductive than effective. In particular, it risks wholly negative social outcomes such as inefficiency and corruption.

Interestingly, the corporate social responsibility website [www.iblf.org/csr/] is itself mild and persuasive rather than assertive or moralistic in tone. The site draws attention to three levels in what it sees as an emerging governance framework: national regulations, international conventions, and voluntary standards. At the first level, national regulation, there is recognition that all companies, regardless of jurisdiction, are obliged to comply with the company law, labour, safety and environmental standards, of the countries in which they operate. Beyond this there is a second level of internationally agreed conventions on an increasing number of issues. Among the most important, of course, are conventions on labour, environmental and human rights issues. These are increasingly used by global corporations as a basis for judgement and decision making. Then, there is an emerging third level of voluntary standards. These are varied and are often established by specific industry groups for their own purposes, and to promote competition among companies within a sector on equal terms. Some involve accreditation systems; others offer guidelines.

So what is the overall, contemporary reality? To this observer there are three developments taking place. One is that as more and more big companies develop regional and global operations, we see more and more of them confronting differing local standards and accepting at least some measure of corporate responsibility for lifting standards in the poorest and least sophisticated environments in which they operate. They do so, if for no other reason, in order to avoid public criticism in their home country and in their markets. Second, in an information-rich and increasingly integrated world, with increasingly active shareholder groups, we see companies giving far more structured attention than in the past to factors which may potentially impact on their corporate and brand reputations. Third, as ever, it is more than just comforting for corporate kings and their professional managers to seek a place on the moral high ground. There are often direct benefits in terms of recruitment and retention of high quality staff in doing so. In short, there is indeed a trend towards enhanced CSR and we only need to examine corporate self-interest to explain it. It is important to note, however, that legislation and compulsion is unlikely to be a good way to foster this trend. It is also salutary to keep in mind that while big business, in its present phase of development, may well be able to take on some community responsibilities more effectively than some governments, they cannot and should not usurp the role of government. It is political processes, alone, not corporations, which have the legitimacy to make social choices for the community at large. This means that the entire, complex bundle of issues we think of as CSR is probably better approached with hard-nosed caution than with messianic enthusiasm.

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The Impact of Relations between Mexico and the United States in the Face of Strengthening Sino-American Commercial Ties

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Abstract

Since 1979, the People's Republic of China has initiated a series of economic reforms with the purpose of boosting and opening up its economy. Since then its foreign trade has been expanding and has now placed China as the world's seventh most important exporter. At the same time, due to a strategy in 1982 of opening up economic zones, China has managed to attract capital and technology helping her to expand and to diversify her manufacturing base. Since 1979 when the United States managed to open up relationships with China, commercial relations, overall, have grown in an exceptional way. From the beginning of this century, two events have marked the relationship of China with the United States impacting the geopolitics of the North America Free Trade Agreement (NAFTA). In November 2001, China was formally accepted into the World Trade Organization (WTO). Currently its commercial exchange has grown with the whole the world, but particularly with the United States and to such a degree that in 2003, China dislodged Mexico as the United States' second most important supplier after Canada.

Introduction

Relations between China and the United States were re-established on February 28th 1972 with the visit of U.S. President Nixon and the "Official Communiqué of Shanghai". In this meeting, a framework was set up, on December 16th 1978, so that finally, bilateral diplomatic relations could be reestablished and ambassadors could be exchanged on January 1st 1979. Subsequently, it was arranged for Chinese Premier Deng Xiaoping to visit Washington. As a result of this visit, each president who has reached the White House has visited China at least once during his administration, just like the most important personalities of the elite in Beijing, who always have corresponded in terms of attention to their counterparts. Nevertheless, this relation has had its highs and lows and has been a relation centred on the paradox of conciliating political interests with the economic interests. There have been moments reflecting closeness, but others reflecting open hostility.

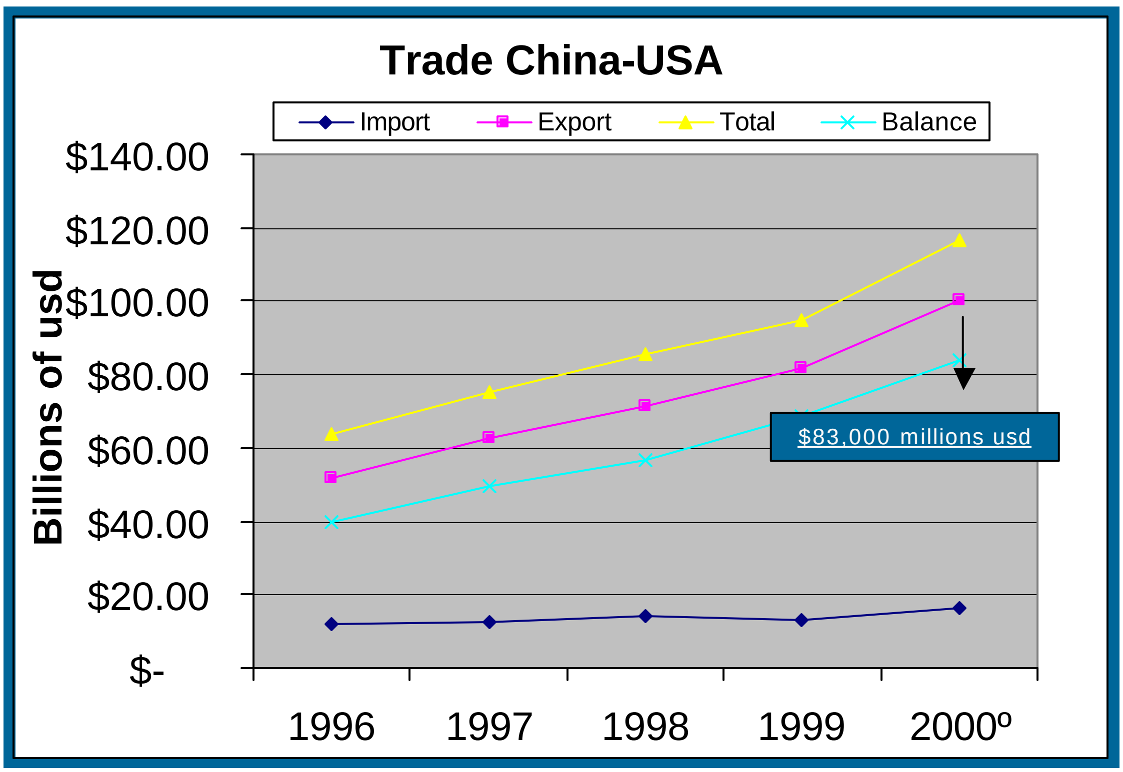
Perhaps the second half of the eighties was one of the best times for the relationship. Nevertheless, after the Tiananmen Square incident, relations entered a rut. The most conservative groups had ammunition with which to justify their hostile attitude towards China. It was not until the administration of William Clinton that the White House decided to give preference to commercial relations over political considerations despite ample and strong opposition from some members of congress and labour unions (1).

For its part, China initiated a series of reforms, which were economic in nature. She gave herself the task of, on one hand, attracting direct foreign investment and, on the other, opening up its markets beyond its borders. Regarding the first task, the results were outstanding, with the creation of four strategic economic zones in coastal areas, where the Chinese managed to attract capital as well technology. To achieve a successful conclusion, in the second part of its strategy, China needed to assure its entry into the U.S. market on favourable terms, that is to say by obtaining the most favoured nation status. As well as being lengthy, this process caused, year after year, tensions with the United States, because some congressional representatives and leaders of diverse organizations used these discussions to condemn the lack of human rights in China, among many other issues.

Therefore, from 1986, China made reaching an agreement in GATT one of its priorities. However, she ran into problems with an American congress and administration in Washington that was against the project and with a GATT that was on the verge of initiating the Uruguay Round. It would have meant having to negotiate new issues, with which China would have found impossible to comply. Therefore, the "long march" began in China's entry into GATT, which became the WTO in 1995, including bilateral negotiations with the United States. Discussions largely centred on linking China's membership to the WTO with commitments that went beyond the purely economic sphere, to specifically accelerate political and social reforms with a tendency, according to the West, on democratising the Chinese state, guaranteeing freedom and social rights. China gave a series of commitments to observe the overall economic and commerce plan, giving the hope that over the medium term they would be able to undertake other possible reforms (2).

Finally, China is accepted officially into the WTO, December 2001, and from that, moment China's foreign trade has boomed. In 1999, for example, 31% of China's total sales were exported to the United States. In 2003, this figure is expected to reach 40%, making the United States the principal destination of Chinese goods in overseas markets. As outlined in the Tab. 1, this situation has meant that the deficit of the United States with China has reached the $83,000 million dollars (according to the statistics from the United States Department of the Commerce). This figure not only reflects the biggest deficit that the United States has with any country in the world, almost 20% of its total world-wide deficit, but also its most imbalanced commercial relationship, since its trade with China only represents 5% of its total commerce. The United States exports to China only 2% of its total sales (3).

TABLE 1. FOREIGN TRADE BETWEEN CHINA AND THE USA



Tab. 2 highlights the imbalance in foreign trade, as well as the growing deficit. Until China's entry into the WTO, the country that had the greatest deficit with the United States was Japan. From 2002, the deficit shifted towards China (4).

In addition, Japan and the European Union (EU) have increased considerably their commercial dealings with China. Japan, as well as the EU, imports much less and exports much more to China than the United States does, but nevertheless they also have a deficit with China, as can be seen in table 3 (5).

TABLE 2. TOTAL USA –CHINA TRADE (THOUSANDS OF MILLIONS OF DOLLARS)

Total Trade China-USA (billions of dls.)

	1996	1997	1998	1999	2000°
Import	$ 12.00	$ 12.80	$ 14.30	$ 13.10	$ 16.30
Export	$ 51.50	$ 62.50	$ 71.20	$ 81.80	$ 100.10
Total	$ 63.50	$ 75.30	$ 85.40	$ 94.90	$ 116.40
Balance	$ 39.50	$ 49.70	$ 56.90	$ 68.70	$ 83.80

Source: The United States-China Business Council (2001)

TABLE 3. DEFICIT FROM THE MAIN TRADE PARTNERS WITH CHINA IN 2000

Deficit from the main trade partners with China in 2000
(millions usd)

	USA-China	Japan-China	EU-China
Export	$ 16,000	$ 30,400	$ 27,800
Import	$ 103,000	$ 55,100	$ 61,200
Balance	*- $ 87,000*	*- $ 24,700*	*$ 33,400*

The strengthening of China's exporting ability has directly affected, not only those countries that compete with the same products as the Chinese, but also on competition within the most important market in the world, which is the United States. In this respect, Mexico has been the country most affected, since more than of 90% of its commerce is concentrated on exports and imports within North America, mainly the United States(6).

Therefore, the competition from China within NAFTA has already displaced Mexico as the United States' second most important commercial partner. This situation has put foreign investors in a difficult situation when considering whether to continue investing capital in Mexico. The short-term result has been that the world's principal multinational companies have decided to invest in, or to move to their plants and facilities in Mexico to, China. It would seem that the benefits that Mexico had obtained from signing the agreement on NAFTA with the United States are now disappearing. Despite the factor of geographic proximity, companies with foreign capital are considering as a priority the market and the facilities that China offers against the benefits offered by Mexico (7).

Relations between the U.S. & China since China's Entry into the WTO

Since 2000, a report has been commissioned every year by the U.S. Congress on bilateral relation with China. This report is undertaken by a group of experts from several organizations, from the Secretariats of State, Defence and Commerce, and includes independent academics, experts in military and economic affairs, and business and labour union leaders.

The last report, July 2002, entitled U.S.-China Economic and Security Review Commission, had the objective of analysing the implications on national security, the United States' economic relations with China, so that the executive and the legislature act jointly and expeditiously through a coordinated national effort.

The most important findings of report were: a) the government of the United States is *poorly* organized to administer its growing relationship with China; b) the United States is not *adequately* informed about developments within China and dedicates few resources to understanding the country; c) the Congress must expand the capacity of the U.S. government to collect, translate and analyze materials in Chinese; d) Congress will have to provide federal funding and other incentives to strengthen Chinese studies and related areas in U.S. universities, very similar to the 1958 national defence education act regarding the USSR; e) Chinese leaders aim to maintain good and stable relations with the United States because it is an important market and source of technology, financial capital and investment; f) this lack of understanding has *provoked errors* (a lack of monitoring), from a dependency of the military industrial base on Chinese imports to the transfer of the latest technology, an unbalanced commercial trade deficit and lack of analysis of a correlation with unemployment in the United States; and finally, g) Chinese leaders think that the United States, although technologically superior in military aspects, can be defeated through tactics and the Chinese philosophy of "feeding off the weaknesses of your opponent", taking as an example the failure of the United States in Somalia.

Impact on the Mexican Economy Due to the Complexity of Commercial Relations between China and the United States

Although China does not have a Free Trade Agreement with the United States, its bilateral relations, and not just economic and commercial ties, but also its political ties, have pushed Mexico-American relations onto the back burner. The current bilateral agenda between China and the U.S.A. is so widespread and complex on one hand, and so strategic for both sides that the government of Washington has considered it as its most important relation. This relation at the moment is being reviewed in several areas, especially in: a) foreign trade between the United States and China, due especially to the enormous commercial deficit that has been created; b) American multinationals and their investment in China, helping to create the biggest exporting platform in the world; c) the entrance of China into the WTO; d) United States' foreign policy towards China in the struggle for the regional hegemony in the Asian Pacific; e) the increasing dependency of the American military industrial base, according to U.S. internal reports, on Chinese high technology products (8).

Therefore, Chinese competition in the North American market is becoming stronger and stronger. On one hand, more and more U.S. multinational companies are relocating to China using it as an exporting platform which is not only flooding the U.S. market with goods manufactured in China, but also developing markets, such as that of

Mexico. This is part of the problem of contraband goods, in that in spite of the product being made in China, the merchandise is labelled by U.S. companies and from there enters Mexico, taking advantage of NAFTA.

On the other hand, every day more and more of international companies are investing in Chinese high technology companies, putting an end to the myth that all Chinese products are of poor quality and labour intensive. At the same time, it is important to note that all this investment and technology transfer has been established not just by the United States, but also by Japan, South Korea and Europe in what are called Special Economic Zones, which have been created to maximise industrial capacity and according to the knowledge of each type of industry (10).

Therefore, we have ports like those of Shenzhen, which have managed to create productive chains and suppliers of excellent quality and delivery times in such industries as vehicle manufacture, textiles, machinery, etc. Starting with only five economic zones created at the beginning of the 1980s, today there are more than 100 such areas or regions, which promote the arrival of capital, technology and jobs in the same way as when the first zones were created (11).

These strategies have led to U.S. investment in high technology manufacturing goods companies being established in ever great numbers in Chinese coastal areas. It is interesting to note that even in this area the United States runs up a deficit with China. As we can see in Table 4, in just one decade, Chinese exports are higher than the imports of US capital goods. This situation led to a deficit of $6,120 million dollars in 2001. The figure of just $160 million dollars which China exported in high technology goods to the United States in 1990 has reached $13,360 million dollars in 2001, an 8,126 per cent variation (12).

TABLE 4. UNITED STATES -CHINES HIGH TECHNOLOGY TRADE IN MILLIONS OF DOLLARS

Trade USA-China Goods of High Technology (GHT) (millions usd)

	1990	2001	Variation
Export	$1,240	$ 7,240	*483%*
Import	$ 160	$13,360	*8,126%*
Balance	$1,080	- $ 6,120	

On the other hand, in undertaking a minute analysis of US-China bilateral trade within the area of high technology goods, we can see that of the 100 percent of trade in 2001, the United States had a 81-per-cent trade deficit in these goods. The total US trade deficit reached $5,400 million dollars, against a surplus of only $500 million dollars, concentrated in airplanes and space vehicles, photographic, optical and measuring equipment as can be seen in Table 5 (13).

TABLE 5. US- CHINA TRADE IN HIGH TECHNOLOGY IN 2001. MILLION OF DOLLARS

Total Trade USA-China Goods of High Technology in 2001

Areas	(100%)	Status	Accumulate (million usd)
Mechanical Equipment, including computers	46%	Deficit	“
Electric Machinery	35%	Deficit	$ 5,400
Aircrafts and Space aircraft.	12%	Surplus	“
Photography equipment, optic and measurement.	7%	Surplus	$ 500

In Tab. 6, we can appreciate, that apart from U.S. investment in high technology goods, U.S. investment has turned to the installation or creation of strategic alliances in other sectors, as for instance in the manufacture of electronic equipment. In this sector, the United States has invested more in terms of amounts and percentages than in all its investments in China. The United States also invest highly in petroleum extraction projects. At the same time, one can appreciate the growing amount of investment in financial and banking services. This, to a large extent, is due to China’s negotiations to enter the WTO (14).

TABLE 6. POSITION OF FDI OF THE UNITED STATES IN CHINA BY SECTORS. THOUSANDS OF MILLIONS OF DOLLARS

Position of FDI from USA to China per Sector

Sector	investment position in 2000 (Musd)	% from the total in 2000	% of increasing 1994-2000
Oil	1,846	19.3%	106%
Food manufacture	181	1.8%	38%
Chemical manufacture	245	2.6%	11%
Metalic manufacture	183	1.9%	76%
Machinery manufacture	931	9.7%	N/a
Electric Equipment manufacture	3,208	33.5%	1,787%
Transport Equipment manufacture	147	1.5%	N/a
Other manufactures	768	8%	252%
Wholesale Trade	362	3.8%	168%
Banks/Finances/ Services	1,113	11.6%	179%
Others	594	6.2%	357%
Total	9,577	100%	275%

Conclusion

Growing Sino-US trade and political relations have left Mexico off the radar screen, even with NAFTA, Mexico's geographical proximity and a government with favourable tendencies toward the U.S., at least up until 11th September. Even more than China's entry into the WTO, its presence in the U.S. market has grown to such a point that it has displaced Mexico in the first months of 2003 as shown in Tab. 7 and 8.

TABLE 7. VALUE OF TOTAL MEXICAN AND CHINESE EXPORTS TO THE USA IN 1990 -1992
THOUSANDS OF MILLIONS OF DOLLARS

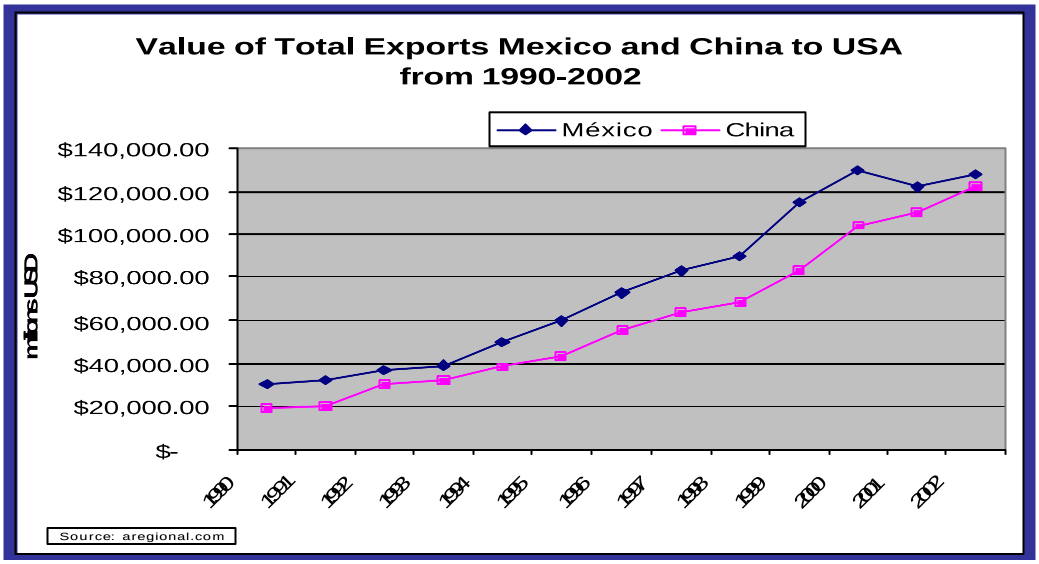
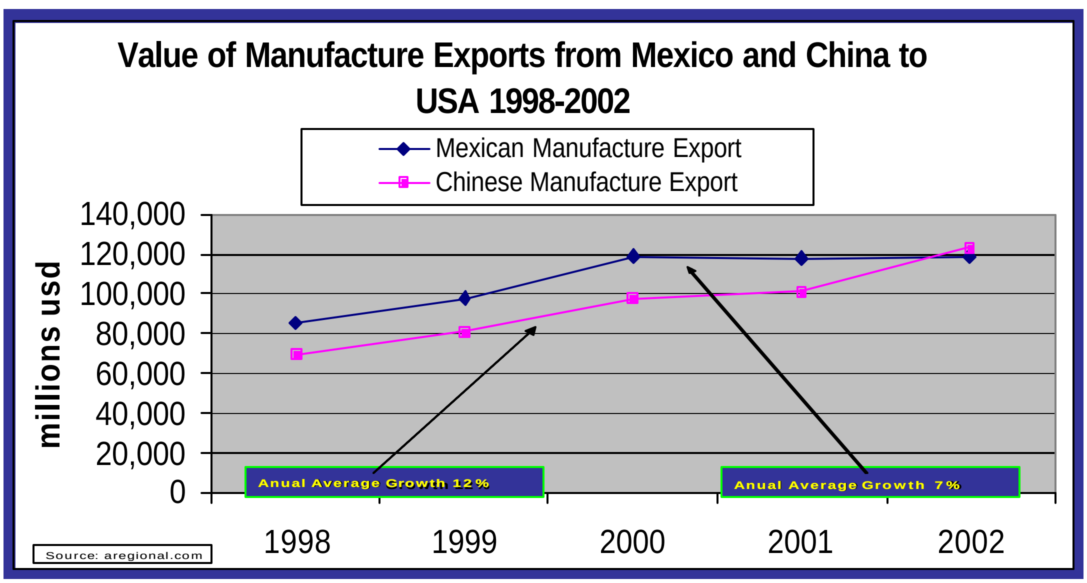


TABLE 8. VALUE OF MEXICAN AND CHINESE MANUFACTURING EXPORTS TO THE USA 1998-2002.



In the final analysis of the different sectors, we can see that there are sectors where Mexico cannot nor will not be able to compete with Chinese goods, such as in toys, furniture, computer accessories, and sound equipment, among others. Nevertheless, there are sectors dominated by Mexico and where China will not present a threat, at least over the medium term. Here we can mention especially the automobile and automobile parts industries. There are two other areas, which can be seen in table 8, where there is strong competition and where they are fighting to the last. It is here where Mexico will have to determine its strategies and the resources that can be put to the aid of the country's companies.

TABLE 9. CATEGORIES OF THE PRINCIPLE MANUFACTURING ACTIVITIES ACCORDING TO THE TYPE OF COMMERCIAL COMPETITION BETWEEN MEXICO AND CHINA

Categorization of Manufacture Branches according with the type of Trade competition between Mexico and China

Branches of Mexican Dominium (no threat short and medium run)	Chinese competitiveness in Branches of Mexican dominium (red warning)	Mexican competitiveness in Branches of Chinese dominium (China is growing)	Branches of Chinese Dominium (due in part for the EZZs and FDI)
(1)	(2)	(3)	(4)
Automobile	Industrial Machinery	Home Appliances	Toys and entertainment products
Automobile Accessories and its parts	Instruments of Mesurament and Control	General Equipment	Sintetics and cotton Cloth and Textiles
New and second hand Autobuses	Computers	Writing and drawing devices	Computer boards and Typewriting machines
Complete and assembly trucks	Telecommunications equipment	Sport Shoes	Computer appliances
Motors y its parts	TVs and VCRs	Kitchen tools and devices	Furniture and home devices
Process products of iron and steel	Electric Generators and accessories		Stereos and Audio equipment
	Electric Appliances		
	Textiles and cotton fabrics		

Fuente: aregional.com

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Institutions of Economic Freedom, Political Competition, and Economic Growth

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Abstract

Institutions that promote economic freedom (i.e. personal choice, protection of private property, and freedom of exchange), are usually regarded as being fundamental for the process of economic growth. That these institutions affect the performance of economies is hardly controversial. Neither is the notion that the differential performance of economies over time is fundamentally influenced by the way they evolve. The question is: "*how* do these institutions evolve?" In a seminal paper, Acemoglu and Robinson (2002) argue that countries experience institutional evolution and economic growth at two extremes: when the incumbent ruler is highly entrenched and faces small political competition or when he is not entrenched and faces high political competition. This paper presents a cross-country analysis testing Acemoglu and Robinson's political theory of institutional evolution. We also test the positive correlation between institutions of economic freedom and economic growth. In both cases our results are consistent with the theoretical predictions.

1. Introduction

There is widespread agreement that institutions (the laws and informal conventions within societies that both permit and bound economic behavior) matter a great deal in the process of economic development. In particular, institutions that promote economic freedom (i.e. personal choice, protection of private property, and freedom of exchange) shape economic incentives, and via this channel have a first-order impact on economic growth.[1]

Formally, institutions determine the ``economic rules of the game'' - in particular, the definition of property rights, the set of contracts that can be written and enforced, and the rules and regulations that determine the freedom of exchange and personal choice. Common examples of institutions include, therefore, individual property rights, commercial and contract laws, price controls, discriminatory taxation, etc.

That institutions affect the performance of economies is hardly controversial. Neither is the notion that the differential performance of economies over time is fundamentally influenced by the way institutions evolve. The question is: "*how* do these institutions evolve?" Could a country in which "bad" institutions are employed improve them? And conversely, could a country with "good" institutions hope to sustain them? Why are many countries unable to change the institutional set for long periods of time, consequently suffering from institutional and economic ossification?

Following Acemoglu and Robinson (2000, 2002), we believe that an important part of the answer to the previous questions is found in the dynamics of the country's political power distribution. The argument is that an institutional change not only has a growth effect, but also a redistributive effect in the economy. In particular, the adoption of a new institutional set may change both the economic and the political power distribution among different groups of the population. Groups with political power (incumbent rulers) may, therefore, block institutional change when they are afraid that this change will destabilize the existing system and increase the probability of losing this power.

Acemoglu and Robinson call this phenomenon the 'political loser hypothesis' or 'political replacement effect.' Due to the economic and political turbulence generated by an institutional change, citizens may be more likely to replace an incumbent ruler who has adopted the change than one that has not. The incumbent ruler, therefore, has a trade-off between the positive effect of increasing rents conditional on maintaining power and the negative effect of increasing the likelihood of being replaced.

The political replacement effect suggests that a Coase Theorem type of logic, maintaining that institutional changes that increase the size of the social pie will always be carried out, does not apply. There is no credible way of ex post compensating the political rulers who lose their power.

The implication, in terms of economic development, is twofold. On one hand, countries might experience institutional change and growth if the incumbent ruler is not entrenched (faces high political competition) or if he is highly entrenched (faces small political competition). On the other hand, however, countries might not experience institutional change nor growth if the incumbent ruler's political position is just somewhat entrenched and fears replacement. If we were to graph it, this relation would take a U shape with institutional adoption on the vertical axis, and the degree of entrenchment or political competition on the horizontal axis.

The first growth path follows a competitive market type of logic: the incumbent ruler has incentives to adopt an institutional change because if he does not he is likely to be replaced by the citizens. The second growth path rests on the incumbent ruler's security of keeping his political power after adopting an institutional change. This security is the result of enjoying a high degree of political entrenchment. An important source of entrenchment, emphasized by Acemoglu and Robinson, are the strong political coalitions that elites are sometimes able to form. They show how groups with political power may be willing to concede some of this power and associate with other groups. In this way, they manage to keep their position, and rents, even after an institutional change. They argue that this were the cases of Britain, Germany, and Japan in the nineteenth-century.

Despite the appeal of the previously described theory we do not know of empirical research developed to tests its arguments. This paper attempts to do so. Using a sample of 59 countries, we run a cross-country regression analysis which results are consistent with the theoretical predictions of Acemoglu and Robinson. We also provide a robust support of the positive relation between institutions of economic freedom and economic growth. The data used is derived from the Index of Economic Freedom 1975-1995 constructed by Gwartney, Lawson, and Block (1996), and the Legislative Index of Political Competition (LIPC) constructed by Beck, Clarke, Groff, Keefer, and Walsh as part of their Database of Political Institutions (2001).

The next section presents a description of the data used for our analysis. Section 3 tests Acemoglu and Robinson's (2002) political model of institutional evolution. Section 4 presents an analysis of the relation between institutions of economic freedom and economic growth. Section 5 concludes.

2. Data Description

2.1 The Index of Economic Freedom

The first set of data we need is an index of institutional adoption. We need a measurement that combines the central institutional elements affecting property rights, freedom of exchange, and personal choice into one overall magnitude.

We were fortunate to find that this task was already accomplished in the Index of Economic Freedom 1975-1995, constructed by Gwartney, Lawson, and Block (1996). This index combines 17 components grouped in four major areas: I. Money and Inflation, II. Government Operations and Regulations, III. Takings and Discriminatory Taxation, and IV. Restrictions on International Exchange. Table 1 provides a description of each component of the index.

TABLE 1: COMPONENTS OF THE INDEX OF ECONOMIC FREEDOM

I. Money and Inflation (Protection of money as a store of value and medium of exchange)
A. Average Annual Growth Rate of the Money Supply During the Last Five Years Minus the Potential Growth Rate of Real GDP
B. Standard Deviation of the Annual Inflation Rate During the Last Five Years
C. Freedom of Citizens to Own a Foreign Currency Bank Account Domestically
D. Freedom of Citizens to Maintain a Bank Account Abroad
II. Government Operations and Regulations (Freedom to decide what is produced and consumed)
A. Government General Consumption Expenditures as a Percent of GDP
B. The Role and Presence of Government-Operated Enterprises

C. Price Controls - the Extent that Businesses are Free to Set Their Own Prices
D. Freedom of Private Businesses and Cooperatives to Compete in Markets
E. Equality of Citizens Under the Law and Access of Citizens to a Nondiscriminatory Judiciary
F. Freedom from Government Regulations and Policies that Cause Negative Real Interest Rates
III. Takings and Discriminatory Taxation (Freedom to keep what you earn)
A. Transfers and Subsidies as a Percent of GDP
B. Top Marginal Tax Rate (and income threshold at which it applies)C. The Use of Conscripts to Obtain Military Personnel
IV. Restraints on International Exchange (Freedom of exchange with foreigners)
A. Taxes on International Trade as a Percent of Exports Plus Imports
B. Difference Between the Official Exchange Rate and the Black Market Rate
C. Actual Size of Trade Sector Compared to the Expected Size
D. Restrictions on the Freedom of Citizens to Engage in Capital Transactions with Foreigners

Source: Gwartney, et. al., (1996)

The authors of the index assembled the data and rated countries on a zero-to-ten scale for each of the components, with zero representing no economic freedom and ten representing high economic freedom. They propose three alternative ways to weight the components into an aggregate summary rating. For the *Equal Index (Ie)*, the simplest alternative, they assign each component a weight equal to the inverse of its standard deviation. For the *Survey Index (Is1)*, they ask knowledgeable people to provide their estimates for the importance of each component.[2] For the *Survey Index (Is2)*, they ask a large number of people who are familiar with specific countries to rate those countries' overall economic freedom on a common scale, and then regress the 17 components on these country ratings, deriving the implicit weights.

The authors present each of the three summary indices but strongly recommend the use of Is1 "because it reflects the views of a sample of people who have thought seriously about economic freedom and the importance of various ingredients of that freedom." We follow their suggestion.

To measure institutional adoption we use two different approaches. The first one consists of taking the *change* in Is1 from 1975 to 1990. This approach captures both, active institutional adoption (countries that show positive change) and active institutional blocking (countries that show null or negative change), during that period of time. The second one consists of taking the *level* of Is1 at specific points in time. This approach is less intuitive and requires some explanation. In a sense, one may argue that the level of these institutional measures reflect institutional adoption that occurs every period. For instance, the definition of property rights must occur each period or it reverts back to the situation in which they are absent. Thus, the level measure reflects the extent of innovation that occurs in a given time period - it is the change over a condition of no innovation. For this approach we use single components of Is1 chosen for their relevance as institutional variables.

2.2 The Degree of Entrenchment or Political Competition

The second set of data we need is a measure of the degree of entrenchment or political competition faced by the incumbent ruler. We use the Legislative Index of Political Competition (LIPC) constructed by Beck, Clarke, Groff, Keefer, and Walsh as part of their Database of Political Institutions (2001). The core of this index is the number of parties that could and did compete in the last election. Countries are rated on a seven-point scale, with one representing no political competition and seven representing high political competition. The categorization of the index is as follows:

1. No legislature
2. Unelected legislature
3. Elected, one candidate
4. One party, multiple candidates

5. Multiple parties are legal, but only one won seats (because other parties did not exist, compete, or win seats)
6. Multiple parties competed and won seats (but one party won 75% or more of the seats)
7. The largest party received less than 75% of the seats

Table 2 shows our data for a sample of 58 countries used by Gwartney, et. al. (1996). The authors divide the sample into three groups based on the countries' change in Is1 from 1975 to 1990: the 17 countries with the largest increase, the 16 countries with the largest decline, and 25 selected middle-rated countries. The second column of the table shows this variable. Table 8 in the Appendix presents Is1 for 1975, 1980, 1985, and 1990.

The third and fourth columns of the table show single components of Is1. The third column shows Ic (Freedom of Citizens to Own a Foreign Currency Bank Account Domestically) in 1985. This is a *dummy* variable that assigns a 10 to a country in which citizens possess this freedom, and a 0 to a country in which they do not. When residents are allowed to maintain bank accounts in foreign currencies, it is easier for them to avoid the uncertainties accompanying an unstable domestic monetary regime, and thus, protect their property rights. Ic is, therefore, an important institutional variable.

The fourth column shows IIc (Price Controls - the Extent that Businesses are Free to Set Their Own Prices) in 1989. The freedom of individuals to use their own property rights and engage in voluntary exchange can be substantially reduced by regulations that limit the scope of business activity and the use of privately-owned property. Price controls interfere with the freedom of buyers and sellers to undertake exchanges even though the terms of trade are mutually agreeable. Price controls also, in effect, take property from a private owner. For example, if price controls on rental housing cut the rate of return of a property in half, in essence, they take half of the property's value from the owner.

The fifth column of the table shows the average of the LIPC during the period 1975-1990. The sixth and seventh columns show this index in 1985 and 1989 respectively. Finally, the eighth column of the table shows the average growth of per capita GDP during the period 1985-1994.

TABLE 2:
INDEX OF ECONOMIC FREEDOM (Is1), LEGISLATIVE INDEX OF POLITICAL COMPETITION (LIPC), AND GDP FOR SELECTED YEARS AND COUNTRIES

Country	Is1 (*)			LIPC (*1)			GDP (*2)
	Δ '75-'90	Ic '85	IIc '89	Av.'75-'90	'85	'89	'85-'94
The 17 countries with the largest increase in Is1 from 1975 to 1990							
Chile	2.9	10	8	1.38	1	1	4.8
Jamaica	2.0	0	4	5.91	5	6	2.1
Iceland	2.0	0	na	7.00	7	7	0.6
Malaysia	2.0	10	5	6.25	6	7	5.0
Pakistan	1.9	0	na	3.44	2	7	2.3
Egypt	1.8	10	2	5.91	6	6	2.4
Turkey	1.8	0	6	5.88	7	7	2.9
Japan	1.7	10	6	6.94	7	7	2.8
Singapore	1.7	10	8	6.00	6	6	5.9
New Zealand	1.7	0	9	7.00	7	7	0.8
Portugal	1.7	0	4	6.60	7	7	3.3
Mauritius	1.7	0	na	6.94	7	7	5.4
UK	1.6	10	8	7.00	7	7	1.8
USA	1.4	10	8	7.00	7	7	1.6
Thailand	1.4	0	4	5.66	7	7	7.6
Indonesia	1.4	10	6	6.81	7	6	4.6
Costa Rica	1.4	10	na	7.00	7	7	2.1
Selected middle-rated countries							

Italy	1.3	0	5	6.94	7	7	2.0
France	1.2	0	6	7.00	7	7	1.6
Ghana	1.1	0	0	1.75	1	1	1.4
Ireland	1.1	0	7	7.00	7	7	4.3
Philippines	1.0	0	2	4.88	6	7	0.8
Australia	1.0	10	6	7.00	7	7	1.6
Sweden	1.0	10	6	7.00	7	7	0.4
Taiwan	1.0	10	6	2.00	2	2	6.7
Israel	0.9	10	0	7.00	7	7	2.2
Canada	0.8	10	8	7.00	7	7	0.9
Spain	0.8	0	6	6.06	7	7	2.7
Bolivia	0.8	0	6	4.38	7	7	0.1
Botswana	0.8	0	6	6.00	6	6	4.6
Argentina	0.7	10	0	4.00	7	7	2.2
South Africa	0.7	0	4	6.38	6	7	-1.4
Belgium	0.4	10	2	7.00	7	7	1.9
India	0.4	0	3	6.88	7	6	2.9
Germany	0.4	10	9	7.00	7	7	2.1
Mexico	0.3	10	0	6.94	7	7	1.2
Peru	0.3	10	2	5.13	7	7	-0.7
Switzerland	0.2	10	7	7.00	7	7	0.7
Guatemala	0.1	10	6	5.88	1	7	0.6
Netherlands	0.1	10	7	7.00	7	7	1.7
Nigeria	0.0	0	4	2.50	1	1	1.1
Zaire	-0.2	0	na	3.75	4	4	-5.3
The 16 countries with the largest decline in Is1 from 1975 to 1990							
Brazil	-0.3	0	0	7.00	7	7	0.8
Sierra Leone	-0.3	0	2	4.31	4	4	-1.1
El Salvador	-0.4	0	na	5.41	7	7	1.4
Greece	-0.5	10	0	7.00	7	7	0.9
Syria	-0.5	10	na	5.69	5	6	0.6
Morocco	-0.7	0	0	5.88	7	7	0.5
Panama	-0.7	10	2	5.13	7	7	0.3
Algeria	-0.8	0	na	4.06	4	4	-2.3
Tanzania	-1.0	0	0	2.63	2	4	0.5
Zambia	-1.1	0	0	4.00	4	4	-1.6
Congo	-1.2	0	0	2.75	3	3	-3.1
Honduras	-1.4	10	0	4.38	7	7	-0.1
Venezuela	-1.4	10	4	7.00	7	7	0.2
Iran	-1.8	10	2	4.31	5	5	-1.7
Somalia	-1.8	0	0	2.38	3	3	-2.3
Nicaragua	-4.4	0	na	5.06	8	7	-3.8

* Higher values indicate greater institutional adoption
*1 Higher values indicate greater political competition
*2 Average Growth of Per-Capita GDP
Source: Gwartney, et. al., (1996), and Beck, et. al., (2001)

3. Institutional Adoption and Political Competition

3.1 Change in Is1 from 1975 to 1990

To explore the relation between institutional adoption and the degree of political competition, we take two alternative approaches when using the change in Is1. First, we use the *level change* in Is1 (column 2 of Table 2), and second, we use the *percentage change* in Is1 (column 2 of Table 2 divided by Is1 1975).

In both cases, and following Acemoglu and Robinson's (2002) model, we expect to find a U shape when plotting Change in Is1 1975 -1990 vs. Av. LIPC 1975 - 1990. This shape is consistent with the hypothesis that countries in which the incumbent ruler is either highly entrenched (faces low political competition) or not entrenched (faces high political competition), evidence institutional adoption. Countries in which the incumbent ruler is just somewhat entrenched and fears replacement, on the other hand, do not evidence institutional adoption. To capture this hypothesis we run least-squares regressions for the two approaches. The regressions take the form:

$$\text{Change in Is1} \ ? \ ?_0 \ ? \ ?_1 \text{Av. LIPC} \ ? \ ?_2 (\text{Av. LIPC})^2 \quad (1)$$

$$\text{Percentage Change in Is1} \ ? \ ?_0 \ ? \ ?_1 \text{Av. LIPC} \ ? \ ?_2 (\text{Av. LIPC})^2 \quad (2)$$

We show the results of our regressions in Table 3. All coefficients have the expected sign and are statistically significant at 5% level. The results of the regression are, therefore, very consistent with the predictions of Acemoglu and Robinson's (2002) model, which lends strong support to their principal hypothesis.

Figure 1 shows the plot of data for the countries and the fitted values when we use the percentage change approach. Again, support for the hypothesis is clearly visible.

Finally, countries like Brazil (BRA), Greece (GRC), and Venezuela (VEN) suggest that high political competition may not be sufficient for institutional adoption. They could also suggest, however, some limitations with the LIPC, in that most of the countries with low Is1 values are developing countries that may truly have slighted lower levels of political competition than countries like Canada (CAN), despite having an identical rank.

TABLE 3: COEFFICIENTS FOR CHANGE IN Is1 1975 - 1990 VS. AV. LIPC 1975 - 1990

Dependent Variable:	Level Change	% Change in Is1
Constant	2.71	0.74
	(0.04)	(0.05)
Av. LIPC	-1.44	-0.35
	(0.02)	(0.04)
$(\text{Av. LIPC})^2$	0.17	-0.04
	(0.00)	(0.02)
Observations	58	58
R^2	0.17	0.12

P-values in parenthesis

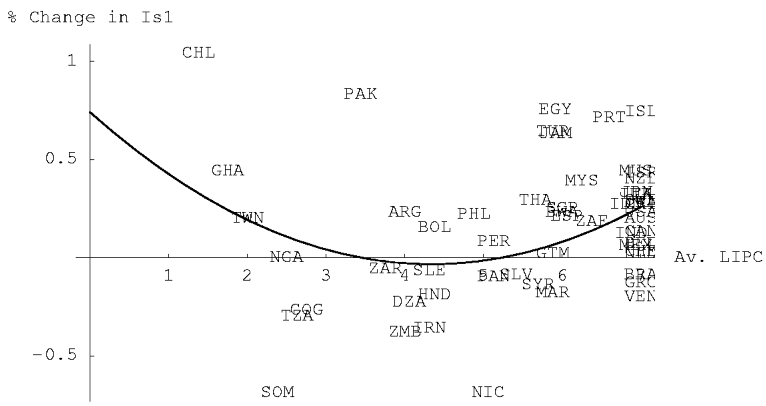

FIGURE 1: PERCENTAGE CHANGE IN IS1 1975 - 1990 VS. AV. LIPC 1975 - 1990

3.2 Level of Single Components of Is1

We now turn our attention to the *level* of single components of Is1 at specific points in time. We take the Freedom of Citizens to Own a Foreign Currency Bank Account Domestically (Ic) in 1985 (column 3 of Table 2), and Price Controls -the Extent that Businesses are Free to Set Their Own Prices (IIc) in 1989 (column 4 of Table 2). In the first case, since the dependent variable Ic 1985 is a dummy one (takes values of zero or ten), we run a probit regression of the form:

$$\text{Ic 1985} \ ? \ ?_0 \ ? \ ?_1 \text{LIPC 1985} \ ? \ ?_2 (\text{LIPC 1985})^2 \tag{3}$$

For IIc 1989, we run a least square regression of the form:

$$\text{IIc 1989} \ ? \ ?_0 \ ? \ ?_1 \text{LIPC 1989} \ ? \ ?_2 (\text{LIPC 1989})^2 \tag{4}$$

We show the results of our regressions in Table 4. All coefficients have the expected sign and most of them are statistically significant at 10% level. Figures 2 and 3 show the plot of data for the countries and the fitted values in both cases. Again, the results are consistent with the predictions of Acemoglu and Robinson's (2002) model.

TABLE 4: COEFFICIENTS FOR for Ic 1985 AND IIc 1989 VS. LIPC 1985 AND LIPC 1989

Dependent Variable:	Ic 1985	IIc 1989
Constant	-	5.68
	-	(0.03)
Av. LIPC	-0.41	-2.01
	(0.06)	(0.15)
(Av. LIPC)^2	0.06	0.26
	(0.06)	(0.09)
Observations	49	58
R^2	-	0.09

P-values in parenthesis

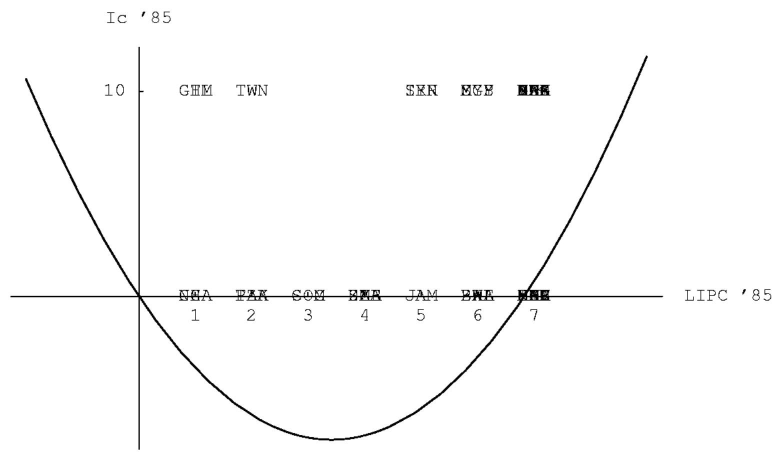

FIGURE 2: IC 1985 VS. LIPC 1985

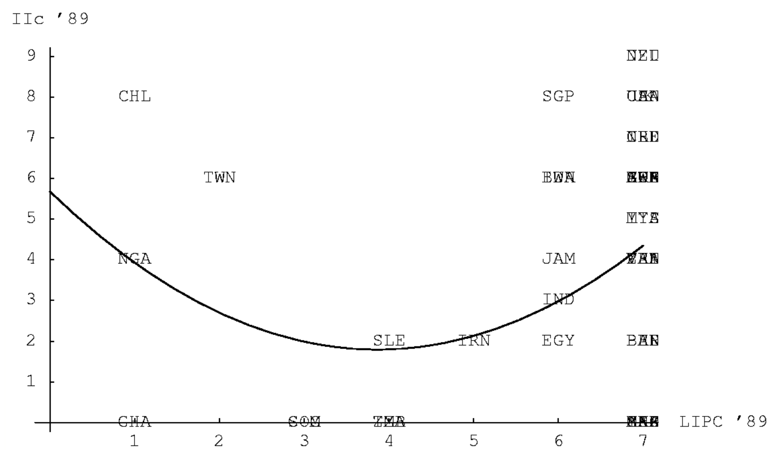

FIGURE 3: IIC 1989 VS. LIPC 1989

4. Economic Growth and Institutional Adoption

Institutional adoption (which we have shown to be related to the degree of political competition) matters in terms of economic growth. To explore this relation we take three alternative approaches. First, we simply regress the Average Growth of Per-Capita GDP 1985-1994 (column 8 of Table 2) on the two different definitions used in the previous section for the Change in Is1 1975-1990. Second, we estimate a traditional Cobb-Douglas production function on average percentage changes during 1975-1990 that includes, besides capital and labor force, the Percentage Change in Is1 1975-1990 as a third input. Third, we take Fischer's (1993) approach to construct the average *Solow Residual* from 1975 to 1990 and then regress it on the Percentage Change in Is1 1975-1990.

The data for the second and third approaches is presented in Table 9 in the Appendix. This table shows the averages of Percentage Change in GDP, Percentage Change in Capital, and Percentage Change in Labor Force for 1975-1990, compiled from The Penn World Data. Our sample was reduced to 53 countries due to the lack of data for some of them. As is conventional in these approaches labor force data, L, is proxied by population estimates. Capital stock data is less readily available and so we constructed it assuming that the growth rate of GDP is equal to the growth rate in capital: $\frac{\Delta \text{GDP}}{\text{GDP}_i} = \frac{\Delta \text{K}(\textit{Investment})}{\text{K}_i}$, therefore, $\text{K}_i = \left(\frac{\Delta \text{K}(\textit{Investment})}{\Delta \text{GDP}}\right)\text{GDP}_i$. For more details see Brada and Mendez (1988).

4.1 Average Growth of Per-Capita GDP 1985-1994 vs. Change in Is1 1975-1990

In this approach we simply regress the Average Growth of Per-Capita GDP 1985-1994 (column 8 of Table 2) on the two different definitions used in the previous section for the Change in Is1 1975-1990: the *level change* (column 2 of Table 2) and the *percentage change*. We have selected growth subsequent to change in Is1 since we expect institutional adoption to have an effect over time. Table 5 shows the results of least-squares regressions of the form:

$$\text{Av. Growth of Per-Cap GDP '85-'94} = \beta_0 + \beta_1 \text{Change in Is1 '75-'90} \quad (5)$$

$$\text{Av. Growth of Per-Cap GDP '85-'94} = \beta_0 + \beta_1 \text{\%Change in Is1 '75-'90} \quad (6)$$

TABLE 5: COEFFICIENTS FOR AV. GROWTH OF PER-CAPITA GDP 1985 – 1994 VS. CHANGE IN Is1 1975 - 1990

Dependent Variable: Av. Growth of Per-Cap GDP	Level Change Is1	% Change Is1
Constant	0.76 (0.00)	0.75 (0.00)
Is1	1.32 (0.00)	4.42 (0.00)
Observations	58	58
R^2	0.47	0.37

P-values in parenthesis

All coefficients have the expected sign and are statiscally significant at 1%. The least-squares results are, therefore, consistent with the intuition behind our model. Figure 4 shows the plot of data for the countries and the fitted values when we use the percentage change approach. A similar graph can be constructed for the other case.

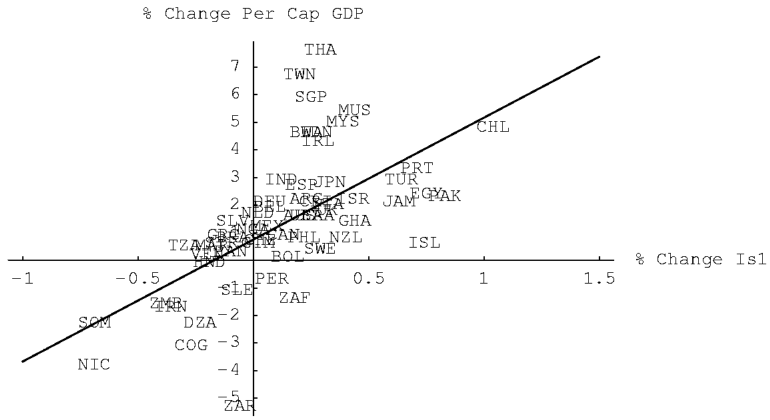

Figure 4: Av. Growth of Per-Capita GDP 1985 - 1994 vs. Percentage Change in Is1 1975 – 1990

4.2 The Cobb-Douglas Production Function Approach

This approach estimates the intensive form of the production function:

$$\left(\frac{\Delta GDP}{GDP} - \frac{\Delta L}{L}\right) = \beta_0 + \beta_1\left(\frac{\Delta K}{K} - \frac{\Delta L}{L}\right) + \beta_2 \frac{\Delta(Is1\ '75\text{-}'90)}{Is1\ '75} \tag{7}$$

The variables (except for ΔIs1) are yearly averages during the period 1975-1990. The estimated equation is:[3]

$$\left(\frac{\Delta GDP}{GDP} - \frac{\Delta L}{L}\right) = \underset{(0.01)}{0.01} + \underset{(0.00)}{0.56}\left(\frac{\Delta K}{K} - \frac{\Delta L}{L}\right) + \underset{(0.00)}{0.02}\frac{\Delta(Is1\ '75\text{-}'90)}{Is1\ '75} \tag{8}$$

All variables and the constant are statistically significant at 1%. Again, the least-squares results are consistent with the intuition behind our model.

4.3 Fischer's (1993) Approach

This approach follows Fischer (1993) to compute the average Solow Residual from 1975 to 1990 an then regress it on the Percentage Change in Is1 1975-1990. Adopting the original formulation, we compute:

$$Res1 = \left(\frac{\Delta GDP}{GDP} - \frac{\Delta L}{L}\right) - 0.4\left(\frac{\Delta K}{K} - \frac{\Delta L}{L}\right) \tag{9}$$

Fischer's approach is a modified growth accounting method. In his formulation the constant is forced to be zero and a value of 0.4 is imposed as a coefficient of the independent variable instead of measuring these parameters statistically. We found from our data, however, that allowing for a non-zero constant the equation becomes:[4]

$$Res2 = \left(\frac{\Delta GDP}{GDP} - \frac{\Delta L}{L}\right) - \underset{(0.02)}{0.01} - \underset{(0.00)}{0.6}\left(\frac{\Delta K}{K} - \frac{\Delta L}{L}\right) \tag{10}$$

We compute the average Solow Residual from 1975 to 1990 following both equations and then regress it on the Percentage Change in Is1 1975-1990 to discover how much of it is explained by institutional adoption. The results are shown in Table 6. The coefficients are statistically significant at 1%. Notice that in the case of Res2 the constant is very close to zero and not statistically significant. This is capturing the fact that Res2 already presents a constant in its construction. Figures 5 and 6 show the plot of data for the countries and the fitted values. Again, this third method confirms our previous results that the empirical evidence is consistent with the intuition that institutional adoption does matter in terms of economic growth.

TABLE 6: COEFFICIENTS FOR SOLOW RESIDUAL VS. PERCENTAGE CHANGE IN Is1 1975 - 1990

Dependent Variable:	Res1	Res2
Constant	0.02	0.0006
	(0.00)	(0.82)
% Change in Is1	0.03	0.029
	(0.00)	(0.00)
Observations	53	53
R^2	0.29	0.24

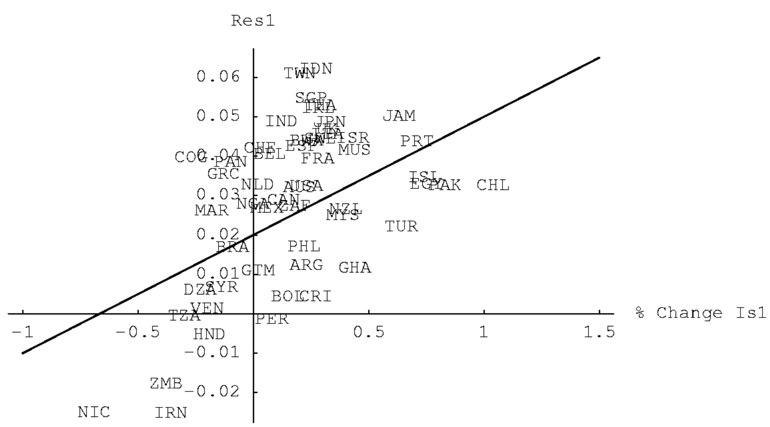

FIGURE 5: RES1VS. PERCENTAGE CHANGE IN IS1 1975 - 1990

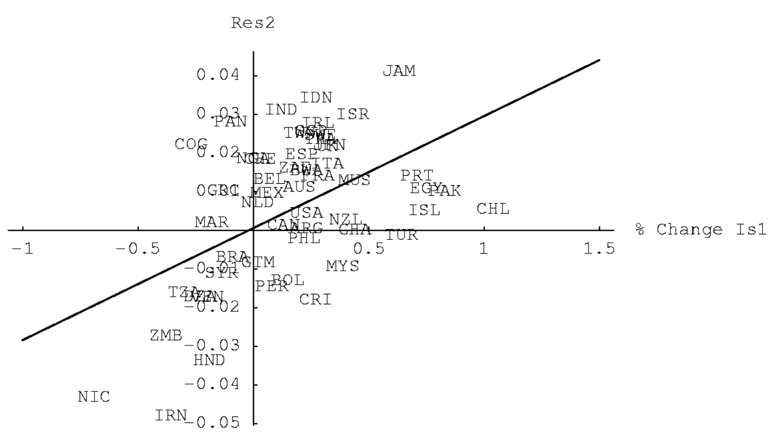

FIGURE 6: RES2 VS. PERCENTAGE CHANGE IN IS1 1975 – 1990

4.4 Forecasting Institutional Adoption and Growth

Our final exercise is to compute the growth consequences of the different degrees of political competition. We first take equation 2 and compute fitted values of the Percentage Change in Is1 for values of the Legislative Index of Political Competition (LIPC) from 0 to 7. Next we use equation 8 to forecast GDP per capita (where the change intensive capital is the mean value over the sample). These forecasts are listed in Table 7. Notice the pattern of per-capita growth rates associated with varying levels of political competition. The table clearly illustrates the relationship between political competition, institutional adoption, and economic growth predicted by our model. It also illustrates the costliness (in terms of economic growth rates) of one degree of political competition versus another.

TABLE 7: FORECASTED VALUES OF INSTITUTIONAL ADOPTION AND ECONOMIC GROWTH IN PERCENTAGES

LIPC (*)	Institutional Adoption (*1)	Economic Growth (*2)
0	74	5.84
1	43	5.22
2	20	4.76
3	5	4.46
4	-2	4.32
5	-1	4.34
6	8	4.52
7	25	4.86

* Average Legislative Index of Political Competition 1975 - 1990
Higher values represent greater political competition
*1 Percentage Change of the Index of Economic Freedom (Is1) 1975 - 1990
*2 Average Change of GDP Per Capita 1985 – 1994

5. Conclusion

Institutions that promote economic freedom (i.e. personal choice, protection of private property, and freedom of exchange), are usually regarded as being fundamental for the process of economic growth. It is crucial, therefore, to understand how these institutions evolve over time.

We contribute on this question by empirically testing a seminal theory of institutional evolution developed by Acemoglu and Robinson (2002). They argue that countries experience institutional evolution and economic growth at two extremes: when the incumbent ruler is highly entrenched and faces small political competition or when he is not entrenched and faces high political competition.

Using a sample of 59 countries, we run a cross-country regression analysis which results are consistent with the theoretical predictions of Acemoglu and Robinson. We also provide a robust support of the positive relation between institutions of economic freedom and economic growth. The data used is derived from the Index of Economic Freedom 1975-1995 constructed by Gwartney, Lawson, and Block (1996), and the Legislative Index of Political Competition (LIPC) constructed by Beck, Clarke, Groff, Keefer, and Walsh as part of their Database of Political Institutions (2001).

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End Notes

[1] See for example Rodrick (1999), Parente and Prescott (1999, 2000), Acemoglu and Robinson (2000), and Easterly (2001).
[2] The participants of the survey were economists that attended at least one conference on Measurement of Economic Freedom jointly sponsored by the Liberty Fund and Fraser Institute since 1986.
[3] P-values in parentheses (the sample consists of 53 countries).
[4] Idem.

Appendix

TABLE 8: Is1 FOR SELECTED COUNTRIES

Country	Is1			
	1975	1980	1985	1990
Chile	2.8	3.9	4.1	5.7
Jamaica	3.2	2.8	4.4	5.2
Iceland	2.7	3.4	3.3	4.7
Malaysia	5.1	5.6	7.1	7.1
Pakistan	2.3	3.5	4.0	4.2
Egypt	2.4	2.8	3.3	4.2
Turkey	2.8	2.3	3.8	4.6
Japan	5.2	5.9	6.5	6.9
Singapore	6.8	7.1	8.0	8.5
New Zealand	4.3	4.8	4.1	6.0

Portugal	2.4	3.1	3.5	4.1
Mauritius	3.9	3.8	6.0	5.6
UK	5.0	4.5	6.0	6.6
USA	6.0	6.2	6.5	7.4
Thailand	4.9	5.0	5.3	6.3
Indonesia	5.2	5.0	6.1	6.6
Costa Rica	5.2	4.8	4.6	6.6
Italy	4.1	3.6	3.6	5.4
France	4.3	4.2	3.4	5.5
Ghana	2.5	2.3	2.8	3.6
Ireland	3.9	4.2	4.2	5.0
Philippines	4.6	4.8	4.9	5.6
Australia	5.0	5.5	5.9	6.0
Sweden	3.5	3.4	4.2	4.5
Taiwan	4.9	5.3	5.5	5.9
Israel	2.1	2.3	2.5	3.0
Canada	6.1	6.8	5.9	6.9
Spain	3.9	3.9	4.1	4.7
Bolivia	5.5	4.5	4.2	6.3
Botswana	3.5	3.5	4.4	4.3
Argentina	3.1	3.6	2.5	3.8
South Africa	3.9	4.6	4.5	4.6
Belgium	5.5	5.7	5.8	5.9
India	3.3	3.8	3.4	3.7
Germany	5.9	6.0	6.0	6.3
Mexico	5.0	3.8	4.1	5.3
Peru	3.7	3.4	3.4	4.0
Switzerland	7.1	7.1	7.3	7.3
Guatemala	6.5	5.7	5.7	6.6
Netherlands	5.7	5.6	5.6	5.8
Nigeria	3.3	4.3	4.3	3.3
Zaire	3.6	3.3	3.3	3.4
Brazil	3.2	2.3	2.3	2.9
Sierra Leone	4.2	3.9	3.9	3.9
El Salvador	4.7	4.1	4.1	4.3
Greece	3.9	3.2	3.2	3.4
Syria	3.7	2.7	2.7	3.2
Morocco	3.9	4.1	4.1	3.2
Panama	7.0	6.6	6.6	6.3
Algeria	3.5	2.4	2.4	2.7
Tanzania	3.3	4.0	1.9	2.3
Zambia	2.9	3.1	2.7	1.8
Congo	4.5	4.0	4.0	3.3
Honduras	7.4	6.1	6.0	6.0
Venezuela	6.9	6.6	5.2	5.5
Iran	5.0	2.5	2.7	3.2
Somalia	2.6	2.5	1.1	0.8
Nicaragua	6.4	3.6	1.8	2.0

Source: Gwartney, et. al., (1996)

Table 9:
GDP, CAPITAL, AND LABOR: AVERAGE PERCENTAGE CHANGES 1975 - 1990

Country	GDP	Capital	Labor*
Algeria	0.062	0.096	0.030
Argentina	0.031	0.024	0.015
Australia	0.067	0.068	0.014
Belgium	0.076	0.087	0.001
Bolivia	0.041	0.058	0.022

Botswana	0.116	0.127	0.035
Brazil	0.065	0.090	0.021
Canada	0.076	0.100	0.012
Chile	0.082	0.101	0.016
Congo	0.084	0.067	0.029
Costa Rica	0.057	0.090	0.028
Egypt	0.082	0.085	0.025
France	0.075	0.081	0.005
Ghana	0.042	0.035	0.028
Greece	0.073	0.084	0.008
Guatemala	0.055	0.072	0.025
Honduras	0.064	0.125	0.033
Iceland	0.084	0.107	0.011
India	0.086	0.060	0.022
Indonesia	0.117	0.109	0.020
Iran	0.034	0.098	0.033
Ireland	0.088	0.079	0.007
Israel	0.073	0.042	0.020
Italy	0.084	0.094	0.002
Jamaica	0.060	0.007	0.012
Japan	0.088	0.089	0.007
Malaysia	0.100	0.149	0.027
Mauritius	0.090	0.104	0.011
Mexico	0.064	0.059	0.023
Morocco	0.076	0.093	0.022
Netherlands	0.070	0.084	0.006
New Zealand	0.061	0.077	0.007
Nicaragua	0.020	0.070	0.029
Nigeria	0.057	0.027	0.031
Pakistan	0.086	0.091	0.028
Panama	0.061	0.024	0.022
Peru	0.029	0.040	0.024
Philippines	0.060	0.070	0.025
Portugal	0.089	0.104	0.006
Singapore	0.112	0.114	0.019
South Africa	0.053	0.030	0.024
Spain	0.074	0.071	0.006
Sweden	0.067	0.052	0.003
Switzerland	0.072	0.070	0.003
Syria	0.055	0.072	0.033
Taiwan	0.128	0.145	0.016
Tanzania	0.043	0.060	0.032
Thailand	0.111	0.116	0.020
Turkey	0.072	0.090	0.023
UK	0.078	0.076	0.002
USA	0.078	0.099	0.010
Venezuela	0.047	0.071	0.029
Zambia	0.013	0.030	0.032

* Total Population
Source The Penn World Data

Are Patents Necessary in the Field of Software and Business Methods?

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Introduction

A patent is defined in Black's Law Dictionary as "a grant of right to exclude others from making, using or selling one's invention and includes right to license others to make, use or sell it[i]." Patents are (subject to some exceptions) "available for any inventions, whether products or processes, in all fields of technology, provided that they are new, involve an inventive step, and are capable of industrial application".[ii] There is a long history of doubt as to the desirability and even morality of patents:

> [Granting of patents] "…inflames cupidity, excites fraud…begets disputes and quarrels
> Betwixt inventors, provokes endless lawsuits, makes men ruin themselves for the sake of getting
> the privilege of a patent, which merely fosters a delusion of greediness.[iii]"

The quotation above is a reminder that there has never been any universal belief in the virtues of patents, and in respect of new innovative ones, such those for software and business methods, there are sharp divisions of opinion as to whether they can even be justified, let alone "necessary".

Software and business method patents ("S&B patents") are the latest incarnation of this doubtful breed and have only recently been recognised as being patentable in the United States ("US"). In 1998 after a landmark case, business method patents were ruled be patentable and much of the restrictions against software patents have now been removed. Such a major change in the law cannot be expected to be without consequences and as will be clear from the text below there are many on going issues of principle and practice which have arisen as a result of this move to recognise S&B patents. The controversy generated by this issue has now spread from the US to Europe where the European Union ("EU") is currently considering whether to follow the US in recognising S&B patents[iv]. There is strong opposition to any moves to introduce patents of this kind from respected members of the science community along with other commentators.[v]

Any examination of the necessity of S&B patents has to include a short account of how they came to be. Since much of the development of S&B patents happened in the US it is necessary to consider the US experience with S&B patents in some detail, as it provides a foretaste to the EU states as they consider whether patents should be harmonised.

At this point it is useful to remember that patents are essentially national in nature and the monopolistic powers attached to them are granted on a country by country basis. Although in recent years international conventions like the Patent Corporation Treaty and the Trade Related Intellectual Property agreement ("TRIPS") of the W.T.O. have made the international award of patent rights far easier than before, patents are still enforced on a country by country basis. Therefore, the legal position in the US is still not the same as that in the UK. However, moves to harmonise patent laws may well change this situation in the future.

The Oxford paperback dictionary partly defines the word "necessary" as an action or an object that is "essential in order to achieve something." The traditional arguments in favour of patents are that they are necessary because it is essential to safeguard the legitimate interests of inventors in their inventions in order to benefit society by encouraging innovation and by increasing its knowledge base. Thus the patent system guarantees a limited term of protection in return for the inventor agreeing to disclose details of his/her invention and ultimately to abandon his/her rights to it, when the patent expires. In other words it is a genre of contractual arrangement between inventors and society[vi].

The question remains are the traditional assumptions behind the necessity of patents true in the case of S&B patents? The answer to this question is found by answering the following questions:

How if at all, do S&B patents benefit society by encouraging innovation?
How if at all, do S&B patents increase the level of knowledge in society?

How if at all, do they help safeguard the legitimate interest of inventors?

Are S&B patents used for building control through the use of monopolies?

As will be clear from the account of how S&B patents came to be accepted as law in the US, there are protagonists who argue that there is no justification for such patents. Also that there are disadvantages to S&B patents which are harmful to both the internet and industry. This raises a further question: Are the protagonists correct, and if so, do the gains from S&B patents outweigh the disadvantages, making the exercise worthwhile?

Patents in General

Not everything can be patentable in the US or the EU. Historically, certain things were found under legislation and common law rulings to be unacceptable for patent. For example, in the US abstract ideas and objects, which occur naturally in nature, were outside the limits of patentability. In the US, courts interpreting section 101 of the Patents Act 1952 have developed over the years rules, which said that concepts like business methods[vii] and software mathematical algorithms[viii] were not patentable.

For a number of years, the position in the US and in the UK remained largely in tandem in that software and business methods were universally accepted as being non-patentable. The landmark judgement in *State Street Bank & Trust Co v Signature Financial Group Inc*. ("State Street")[ix] reversed such thinking and redefined the limits of patent law by opening up business methods for patenting and greatly curtailing restrictions against patenting computer programs.

The State Street Bank & Trust Co v Signature Financial Group Inc. Decision

State Street Bank & Trust Co v Signature Financial Group Inc. ("State Street") centred upon a patent for a computer based system that allowed a financial administrator to monitor and record the flow of financial information as well as to make calculations to maintain a financial services configuration called a "Hub and Spoke" system. The District Court on hearing the case held that the patent was invalid because the claim fell within the patent exceptions of mathematical algorithm and business method. On appeal[x] however, the Federal Circuit Court overturned the lower court's decision, redefining the limits of patent law by overturning the business method exception and significantly curtailing the mathematical algorithm exception. In emphatic language the court stated that business methods were now a legitimate subject matter for patent protection:

> "We take this opportunity to lay this ill conceived exception to rest…Since the 1952 Patent Act, business methods should have been subject to the same legal requirements for patentability as applied to any other process or method." [xi]

On page 1373 of its judgement, the court took the view that Congress, from the language of the Patent Act, did not intend to place restrictions on what could be patented, beyond those laid down in section 101 of the Act. The general processes or methods of conducting business were not caught by the wording of s 101; therefore, the business method exception was an improper expansion of this statue. On page 1375 the court went on to say that the business method exception was "error-prone, obsolete, and redundant".

As to the exception of mathematical algorithms, the court overruled the Freeman-Walter-Abele test[xii] and found that there was a practical application of a mathematical algorithm in this case, because it produced "a useful, concrete and tangible result", stating that:

> "The mere fact that a claimed invention involves in-putting numbers, calculating numbers, out-putting numbers, and storing numbers in and of itself, would not render it non-statutory subject matter."[xiii]

Implications of the State Street Bank & Trust Co v Signature Financial Group Inc. Decision (Aftermath of the Decision)

The major changes to patent law by the judiciary happened without prior consultation or debate. Few members of the public were even aware that it had happened. As the government's patent commissioner later admitted to Lessig during a debate, [xiv] the PTO did not at anytime conduct surveys or studies on what impact the State Street decision might have, and therefore, had not satisfied itself that implementation of the decision would not harm innovation in the development of software or the practice of business.

Fundamental change of this nature begets controversy and scepticism[xv]. The protagonists decried the lack of consultation with interested parties proclaiming that software and business method patents are wrong in principle.[xvi] Pragmatists expounded on the practical difficulties encountered when dealing with such patents.[xvii]

The Patent Flood

Perhaps predictably after the State Street decision there was a "patent flood". [xviii] The PTO received a large increase of applications for the registration of S&B patents. For example, applications to the PTO for patents rose from 920 in 1997, to 1,300 in 1998, and then to 2600 in 1999.[xix]

Periods of patent flooding cause a fall in quality of patents to unacceptable levels and is generally associated with patents on obvious inventions, overlapping claims, and inappropriately broad claims. The reason for the fall usually has to do with the pressure caused by large numbers of patents being processed in a short time. Other factors include a lack of skilled examiners, or a lack of material on "prior art" so that ineffective checks are carried out, and the sheer weight of work to be carried out on the limited resources of the PTO.

It is important to note that software patents do not always cover whole programs; they usually cover algorithms and techniques that form parts of programs. In any given program there can be many different algorithms and techniques because they combine to tell the computer what to do. So a program can have some algorithms which might have been patented by others and some which are not. Any search of the patent system may not uncover software programs in the process of being patented (due to a time lag of 2 to 5 years between the date of application and award). Furthermore, it is possible for different computer programmers to independently write (in different times and places, using different languages) the same algorithm as solutions to different problems. Therefore, the possibility of overlapping patents is a real one and may be impossible to uncover despite a detailed search. To compound matters, the patent system in the US is designed to encourage the award of patents regardless of the quality of applications presented to it. This is evident in the mission statement of the patent department:
"The primary mission of the Patent Business is to help customers get patents.[xx]"

Consequently the processes adopted for the examination of patents are slanted in favour of patent applicants;[xxi] hearings are held in private and opposition to applications are not encouraged. Therefore it is hardly surprising that an overwhelming majority of patents submitted to the PTO are approved. This is supported by Quillen & Webster (2001-2) who found that as many as 97% of patent applications surveyed were accepted by the PTO[xxii].

A System in Crisis

Commentators reviewing the patent law system in the U.S. agree that the continuing deterioration in the quality of patents issued and the declining quality of the system itself due to flooding is propelling it towards crisis point. Professor Robert Merges declared that:

> "The concerns about quality, especially in the light of the data on the overall volume, point to one conclusion: the present system is in crisis [xxiii]."

The continuing escalation of claims led to the head of the PTO, to publicly acknowledge in October 2002 that many business method patents had been wrongfully awarded.[xxiv]

As a direct consequence of the rise in the number of poor quality patents, people in the internet and software industries had to bear high licensing and litigation costs associated with the new patents. There also followed a slow-down in the spread and accumulation in innovation as well as an increase in cases where patents were misused[xxv]. The repercussions of which are still felt today. The question is has it all been necessary?

The Question of Necessity

Are S&B Patents Necessary to Encourage Innovation? One of the basic justifications for the existence of patents was that they were necessary to encourage innovation. In fact Article 1, Section 8 of the US Constitution states:

> "Congress Shall Have Power To […] promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries."

Implicit in the purpose of patents is the idea that it must be used to encourage innovation. Under British law[xxvi], innovation has been taken to mean activity which must have an appreciable degree of novelty. However, the process of innovation is not uniform in all fields of activity. In certain fields where there is discrete technology and one patent usually encompasses only one product, (i.e. Pharmaceutical industry), patents seem to benefit innovation[xxvii].

Innovation in the software industry on the other hand, tends to be cumulative or sequential[xxviii]. In other words, unlike industries such as the pharmaceutical industry, new developments in software are very often built on work that has gone on before. As a direct consequence of which innovators who worked earlier in this field would have a great advantage over people who entered the field later. While it is possible for later entrants to the field to try and design their programs around known patents, innovators who entered earlier can accumulate enough patents to make innovative competition very difficult. The barriers to new entrants (especially small companies) represented by S&B patents can be a formidable obstacle to new players.

The recent patent flood sparked by the ruling in the State Street decision has led to patents being awarded to individuals in generic material that is being used by many in the industry but have never been patented before, because it is material that has always been thought of as in the public domain[xxix]. In September 1997 Amazon.com started offering its one-click feature and received a patent for it in September 1999. In October 1999 the company sued Barneandnoble.com (New York) for patent infringement. In December 1999, Amazon obtained a preliminary court injunction that prevented its competitor from using the one-click system. It won its court case on the strength of a patent which many felt should never have been awarded. The patent was based on a concept that was so basic that many failed to see how it was novel. Patrizio was moved to say of this case, "the one click shopping for Amazon is absurd. What is the original idea there?[xxx]" The injunction was overruled in February 2001. The US District Court in Seattle officially ended the court case on 5th March 2002. Details of the settlement were not disclosed.

Any innovator hoping to develop new software has to ensure that his/her innovation does not fall foul of any patents already awarded or about to be awarded. Normally one would expect to be able to conduct a quick and simple search to discover patents already submitted to the PTO for approval. Unfortunately things are not as simple as that. In practice software developers have been known to slow down or stop development of new innovations if news is received that others have been engaged in the same field of development before themselves. This is for fear of wasted effort or legal action if it is later discovered that the in-house innovation in progress trespasses on another patent. Lessig describes this as the "hold-up" problem[xxxi], which is considered a critical problem for future innovation.[xxxii] It is doubtful that S&B patents encourage innovation as they should. Instead S&B patents appear to encourage the accumulation of patents by certain individuals or firms in the hope that they can benefit, not so much from the development of the patent themselves, but from making easy money by either licensing to others the right to use the patents or by taking them to court. As Kahin[xxxiii] puts it:

> "The licensing market, such as it is, seems to be defined characterised by patentees looking for infringers, rather than productive companies looking for technology."

The Economist magazine [xxxiv] sought to find objective evidence that patents encourage innovation. However, his results concurred with Kahin, in that firms taking out patents tended to do so not so much for exclusive rights, but for strategic purposes instead. The same magazine then conducted a broad range of research into the question: "Do firms become more innovative when they increase their patenting activity?" The findings showed that for the most patent conscious business of them all, the semiconductor industry, the answer was no[xxxv]. This finding is supported by Arundel[xxxvi] who found that a high proportion in the computer industry resort to patents for "tactical reasons", whereas a low percent (13%) of the same industry agreed to the proposition that patents were very "important" or "critical" for innovation.

The accumulation of patents by large firms for strategic purposes is something, which can have an effect not only on the rate of innovation, but also the future survival of small start up firms. As Richard Foster so aptly stated:

"Patents are the traditional way to get or protect a technology. Unfortunately, most corporations are skilled in getting around patents. In many cases patents become important only as tradable assets. They are the ante for getting in the game. If you have a large patent portfolio, as do companies like Bell Labs, IBM, Du Pont, or Hewlett Packard, it's possible to trade patents like baseball cards until you get the set that you want. It is better to have them than not, but patents are rarely strong enough by themselves to prevent leapfrogging." (p. 213)[xxxvii]

As large firms accumulate the lion share of patents they tend to use their portfolios not only as a source of income via the collection of licence fees, they also use their patents as assets in a barter system with other large patent rich firms. Under this informal system, large companies use software and processes covered by other company's patents, and in return for not being sued for patent infringement, the company will allow other companies (who allow them this liberty) to use their processes and software patents. This high stakes bartering favours patent rich companies. Small start up firms may not have enough patents to enter the game and therefore cannot compete. This does not bode well for the process of innovation when history has shown that many of the innovative products and processes have their genesis in small start up firms.

To conclude, it is perhaps useful to recall that the recent leaps of innovation, together with the massive expansion of the computer, software and internet industries all took place without the benefit of S&B patents. Therefore, if it is true that what the world saw happen in the eighties and nineties to those industries was a prime example of innovation at its best, then it seems reasonable to conclude that S&B patents are not necessary for innovation.

Are S&B Patents Necessary to Advance Knowledge in Society?

A second pillar of the traditional argument for patents is that in return for a period of patent protection, patent holders have to reveal enough information about his/her patent to enable others (reasonably skilled in the art) to make practical use of the invention. It is through this disclosure of information and knowledge that society derives its reward for allowing patent holders a period of monopolistic rights.

A preliminary point worth considering is the length of validity for patents. Normally a patent is a legal right, which exists for up to 20 years. Since the useful life of software tends to be for a much shorter period there has to be a question mark over what possible benefit society can gain from a piece of software that is twenty years old.

Secondly, disclosure is a prerequisite of patent protection aimed at ensuring that when the patent period expires others can gain the benefit of the advancement in knowledge represented by the patent. This is supported by the dicta from Grove J (at 31) in *Young v Rosenthal*[xxxviii],

> "He (the applicant) is bound to describe his specification as that any workman…would know how to make it; and the reason of that is this, that if he did not do so, when the patent expired he might have some trade mystery which people would not be actually to use…"

Although this position is a basic requirement of patents the situation with S&B patents is somewhat different. In practice the benefit that society gains from S&B patents do not work out as well as one would hope from the theory stated above. For example, an applicant for S&B patents in the US does not have to disclose his/her source codes, therefore no public record is made of a vital part of the patent.[xxxix]

So it is hard to see how society can benefit from S&B patents when the patent runs out, as only a partial recital of the information is on public record at the US PTO.

Patent quality has deteriorated and when the quality of patents is poor the public is not likely to benefit in terms of any advancement in knowledge. In fact there appears to be very little evidence that much can be learned from patents awarded lately by the PTO. The situation has become so bad that the PTO has decided that the cost of getting the necessary information to judge the patentability of an application has become so high that the exercise exceeds the cost of the benefit. The PTO would rather choose to remain uninformed or "rationally ignorant."[xl] In short, the quality of patents coming out of the PTO recently is unlikely to be of much value in advancing the level of knowledge in society.

In such a situation Kahin[xli] has observed that, "…it appears that patents are not a useful source of knowledge and if knowledge does not flow smoothly and transparently within the system, patents may encourage opportunistic, even parasitic, behaviour rather than meaningful innovation."

What then is the gain for society in allowing the existence of a monopolistic right under a patent? If the ideas behind the current crop of patents are not inventive, incomplete (with source codes missing) and of doubtful quality, it would seem reasonable to doubt that anything useful can be gained by way of new knowledge.

Are S&B Patents Necessary to Safeguard the Legitimate Interests of Inventor?

To ask if S&B patents safeguards the legitimate interests of inventors may at first sight appear to be an odd question. S&B patents are clearly beneficial for people who take them out but part of the reason why society puts up with the monopoly created by patents is that it is necessary for safeguarding the legitimate interests of the inventor. The idea is not for patent holders to have the right to control markets per se, it is to enable them to protect legitimate interests like the investment of time and resources they have invested in their invention. To this end many lawyers in the US claim the ability of small firms to take out patents is the main benefit of S&B patents because they enable small inventors to withstand any pressure exerted by their larger rivals. In essence, they claim that without patent protection, large companies will use their superior financial and marketing resources to force small out of business. Therefore in the absence of patents to safeguard the investment in time & effort of investors, no one could be sure of any reward for the whole process. Many who favour S&B patents often cite the case of Stac Electronics v Microsoft[xlii] as an example where the patent model worked well to protect a small player. This was a case where a large company negotiated with a small firm to use its compression technology. However, when negotiations broke down the large company developed a compression programme of its own as part of its operating system. The small firm then sued and won a jury award of $120 million. This case however should be contrasted with the case of BT v Prodigy[xliii] where BT discovered an old patent it had on hyperlinks that pre-dated the World Wide Web. BT then tried to assert its rights in relation to the patent and sued Prodigy, a company that pioneered an online service then became an internet service provider. If BT had not lost its case it could at a stroke, have gone on to exercise great power over much of the internet and profit from many firms engaged in e-commerce. All of which, would seem grossly unfair considering it was trying to lay claim to a public standard to which it did not contribute and upon which, other people had invested vast sums on the understanding that hyperlinks were things which were open and non-proprietary. This case goes to illustrate that patents are a double edged sword when it comes to safeguarding rights and can work against the interests of small firms just as easily as for them.

Patents have only recently been introduced as a method of regulating intellectual property law rights for software. Up until recently the use of copyright was the main protection for software. Copyright is of course totally unsuitable for protecting business methods because these are pure ideas for procedures and copyright does not operate to safeguard such things. In Europe and elsewhere, copyright has always been the recognised as the proper IP vehicle for protecting things like software. However, many people plainly prefer relying on patents as opposed to copyright because of the greater legal powers under patents. Nevertheless it is useful to recall that for many years the software industry grew at a rapid pace without the use of anything other than copyright law and the law of trade secrets. Companies such as Lotus, Novell, WordPerfect and Microsoft all grew into what they are today without the need for patents. As mentioned above, the size of the software industry today indicates that S&B patents are not essential for either innovation or for the growth of the software industry.

From the above it is clear that there are major problems with using the traditional model of patent law on things like software. Perhaps a new form of patent law could be developed to deal with some of the problems mentioned in this paper. For example, there are plans[xliv] in the EU to bring in a lesser form of patent called the "utility model", which gives only 10 years of protection instead of 20 years. However, at present this model has not been introduced into UK law and it is unclear when this will happen.

It is interesting to discover that computer software innovators themselves have seen the drawbacks of S&B patents and has voiced their reservations. For example, some software writers have been critical of the PTO mistakes in awarding patent software, which is not innovative.[xlv] Elsewhere scientist have joined together to call for a stop to S&B patents being adopted by the EU.[xlvi] And many diverse groups, some as obscure as the British Crystallographic Association, have published papers voicing their concerns about S&B patents and the dangers they represent.[xlvii] All of which seems unexpected in that software writers, scientists and diverse groups working on developing software models like the British Crystallographic Association should have been the very groups that stood to benefit if S&B patents were indeed 'necessary.' Instead the people who appear to be most in favour of S&B patents are either managers of large companies (who get to enforce monopolies through patents when it is otherwise illegal) and IP lawyer.

One other thing used to safeguard the interests of inventors is the law of breach of confidence. Many large corporations have grown into multi-national businesses using trade secrets. For example, Coca Cola and Kentucky Fried Chicken have both built substantial businesses with the use of confidential trade information. Consequently it is doubtful that S&B patents are essential in order to safeguard the legitimate interests of inventors.

Conclusions

"If people had understood how patents would be granted when most of today's ideas were invented, and had taken out patents, the industry would be at a complete standstill today." (Bill Gates in a 1991 memo)[xlviii]

As will be clear from the arguments above, there is little evidence that S&B patents are 'necessary' in the sense that they are essential for promoting innovation, advancing knowledge in society or protecting the legitimate interests of innovators. In fact there are indications that they do harm in the way they were brought about, used and in how they operate.

Perhaps part of the problem here is that there has been little to no discussion about the nature of S&B patents themselves. S&B patents are very different from other kinds of patents because they are patents on concepts and so the abstract nature of S&B patents should have had an influence on the whole idea behind how patents are used. However, this has not happened and everyone treats S&B patents as just another type of patent, much in the same way as a new type of engine or chemical. As Kahin[xlix] points out,

> "Conceptual patents refocus competition on securing broad business monopolies and away from competition at a technological level – the traditional domain of the patent system."

This illustrates that people use conceptual patents like S&B patents in a different way. Very often instead of using a patent to develop a product S&B patent holders will use portfolios of patents to operate in a market. This in turn leads to the question of how patent related restrictions on the operation of the market can be justified in the context of anti trust law in both Europe and the US.[l] Although the issues of S&B patents and anti-trust law will not be looked at here, it is nevertheless relevant when thinking about the 'necessity' of S&B patents to bear in mind the fact that anti- competition aspects of these patents in themselves raise grave issues of public interest.

In conclusion, the issues of S&B patents when looked at in detail appear straightforward. The new patents do not appear to encourage innovation, offer the chance of advancing the knowledge of society or provide the only means of protecting innovator's interest. The harm that they do looks out of proportion to the good they bring about i.e. the protection of legitimate interests of innovators. Yet the EU commission appears determined to introduce S&B patents in order to harmonise patent rights between the US and Europe[1].

Lessig asks an important question on page 217 of his book 'The Future of Ideas',

> "This then presses the fundamental question of this book: If the extreme of these constrains (IP systems) are not necessary, if there is no good showing that they do any good, if they limit the range of **creativity** by virtue of the system of control they erect, why do we have them?"

The question of 'necessity' here has to do with balancing the good that can come out of allowing software and business methods to be patented with the harm that will be caused by doing this. In this case the amo unt of good that can be obtained from S&B patents is at best uncertain whereas the harm that they represent is clear. In which case we should perhaps heed the words of Lucius Cary, Viscount Falkland[2] who once said, "When it is not necessary to change, it is necessary not to change."

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Outsourcing of Justice: Applying the Legitimacy Test of Fairness to the Institutionalisation of International Commercial Arbitration

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Abstract

This paper explores the instrumentality of legitimacy as a fairness indicator. I apply legitimacy to a short sample of NAFTA arbitral awards and juxtapose the NAFTA awards with the trend evolving in the WTO jurisprudence in order to assess to what extent the debate on the institutionalisation [building and regime building] of international commercial arbitration applies both to the WTO DRU and to the NAFTA dispute resolution mechanism.

An argumentative building block in my larger study on the Outsourcing of Justice: International Alternative Dispute Resolution, Free Trade, and Fair Trade, the process leading to legitimisation of, and compliance with legitimacy requirements by, international commercial arbitration, unravels the connection [or disconnect] between trade liberalisation, legal supremacy, and democracy as they converge concerning access to justice and the relationship between the presumed advantages of international law [public and private] harmonisation in dispute resolution and the theory of competitive legal markets.

Introduction[1]

This paper is part of an emerging yet small and kaleidoscopic literature applying a *transdisciplinary* approach to grapple with the elusive transformations generated by globalisation. In earlier studies, I addressed the theoretical frameworks and practical solutions to improve access to justice both in the Pacific Northwest as well as in larger free trade transborder regions [e.g. EU, NAFTA, and WTO]. This paper will take those studies one step further. It will introduce additional analytical detail and evaluate the role of alternative dispute resolution [ADR] in commercial and trade matters in the context of regional market integration and global trade liberalisation institutions. I will continue to elaborate on the underlying proposition advanced in my earlier research namely, that the contours of the "benefit" of regional and global market integration encompass vital questions of justice, and that lack of universal access to justice at these levels amounts both to a non-tariff barrier [NTB] to trade, and to a "trade barrier to justice" [TBJ]. As long as practices of private international law continue to permeate public international law and create privatised legal enclaves as provided by international commercial and trade ADR, justice will remain elusive.[2]

In this paper, I will focus on one particular aspect of access to justice pertaining to the institutionalisation of the dispute resolution law governing regional and international market liberalisation. Namely, I will apply the legitimacy test of fairness to international commercial arbitration as reflected in the adherence of arbitral tribunals to their sphere of jurisdiction in rulings under the NAFTA Ch. 11 and by the WTO Appellate Body [AB]. I will outline various aspects of legitimacy and explore the broader range of fairness and institutionalisation, however, defer the detailed analysis of case studies for a later version of this paper.

Indicators of Fairness: Legitimacy and Distributive Justice

While international relations - as realists maintain - exist in a state of anarchy, law, which consists of rule-based expectations for order, prevents them from slipping into chaos. Even if perceived as purely interest-oriented, international relations require for their maintenance the aid of legal instruments, namely principle-oriented guidance. However, without at least a veneer of fairness, the guidance function of reconciling international relations and law remains mute. Fairness, which has multiple interpretations and appearances, rests on two foundations - a procedural and a substantive.[3] Legitimacy represents the procedural aspect and a necessary condition of fairness "for it accommodates a deeply felt popular belief that for a system of rules to be fair" [Franck, 1995, p. 7] formal requirements of rule making, rule-interpretation, and rule-application must be satisfied. The tenuous relationship in international ADR between theoretical/principled rejection of stare decisis and the practical consideration of precedents serves as one example of procedural inconsistency. The substantive aspect of fairness focuses on distributive justice where burdens and entitlements are shared in a way that encourages voluntary compliance. [Franck, 1995, p. 8] In the contemporary world, the fairness discourse is delineated by two structural circumstances: "Moderate scarcity"[4] and "community". Moderate scarcity refers to the state of "polarities of plentitude and deprivation" [Franck, 1995, p. 11]. Community, which refers to a "social system of continuing interaction and transaction" [Franck, 1995, p. 10] facilitates the reconciliation of moderate scarcity by reciprocity and reasonableness. So far, international law, which attempts to reconcile the state of international relations with the notion of law, has mainly centred on fairness in the commu nity of states. While neither always, nor necessarily, does fairness to states often differ from fairness to persons. [Franck, 1995, p. 12]

To ascertain what is accepted as fairness, incidents of unfairness serve as the easiest available markers. I interpret Franck as suggesting a two-legged test of fairness addressing both procedural and substantive foundations of fairness. The first leg consists of four indicators of legitimacy:

- Determinacy, i.e. clarity and transparency through the language of the law, so as to communicate the law's essential meaning;
- symbolic validation, i.e. reinforcement of legitimacy by signalling that authority is institutionally recognised and confirmed;
- coherence, i.e. generality of the rule evidencing a principled approach [sometimes inconsistent but never capricious] and explaining why a rule compels; and
- Adherence, i.e. the connection between primary and secondary rules, the jus cogens of "peremptory norms" where rules are validated or invalidated by other rules. [Franck, 1995, 30-46]

The other leg of the test addresses the fundament of distributive justice by resorting to equity as representing the substantive source of fairness. There are:

- Corrective equity, i.e. to correct a rule which is too conservative or rigid to be applied without risking killing its spirit;
- broadly conceived equity, where equity itself is a rule of law pertaining to resource allocation; and
- Common heritage equity,, that unlike the two former variations that belong ab initio to states, assumes that "certain resources are the patrimony of all humanity". [Franck, 1995, pp. 76; 58-76]

To pass the fairness test, compliance with both legs is necessary. In other words, it suffices to show failure in one of the legs in order to establish a "defect" state of fairness. A vast literature by environmental and labour (and social justice) critics has already been challenging the fairness of international dispute resolution mechanisms on substantive grounds.[5] In this paper, I will address the legitimacy leg of the fairness test, and refer to distributive justice only where it is intertwined with the legitimacy argument.[6]

What does institutionalisation mean in the context of dispute resolution in liberalised trade regimes?

Through the process of institutionalisation formal institutions and democratic procedures acquire both value in the eyes of the population and stability to withstand pressure. [Huntington, 1968] Institutionalisation, which is a key to the maintenance of law and order, is indeed a form of conflict management, including conflict resolution, and possibly, conflict prevention. In the EU, "institutionalisation" is also understood in reference to "democratic governance", democratic consolidation, and institutional design; low degrees of institutionalisation are interpreted as symptoms of institutional decay or loss of political leadership. [Siedschlag, 2000, p. 3] In other words, institutionalisation pertains to process; the adequacy of the process instructs legitimacy. An example of the process of institutionalisation is institutionalised conflict regulation. Institutionalised conflict regulation prevails when actors have internalised common rules to govern the conflict. When challenged with change, and when rules are externalised [e.g. by the introduction of new NAFTA-made conflict resolution mechanisms for investors, or by establishing a final appeal instance such as the WTO AB], re-internalisation becomes indispensable.[7] Re-internalisation will emerge as a modified institutionalisation of the previous rules.

There are two main routes by which practises and structures are elevated to the level of principles and values, e.g. are being institutionalised: Organisation-building and regime-building. While the former represents the setting up of structures and their operating processes, the latter focuses on legislation. Both are necessarily complementary and intertwined. There are no rules without bodies to create and enforce them; there are no organisations that can survive lawlessness.

Historically, trade expansion had entailed the creation of political coalitions that established new types of institutions [e.g. France, the Hansa, and Italian city-states]. Although occurring sporadically, some of the directions such coalitions followed have become irreversible. [Spruyt, 1994, pp. 184, 186, 187] Irreversibility, which suggests that a state of institutionalism has been achieved, is also a necessary however insufficient condition of legitimacy.[8] Indeed, legitimacy is assured only through the intermediary of the state:

Although the abilities of the state vis-à-vis society might have changed [private actors resorting to self-help], the institutional principle of sovereign, territorial rule as the foundation of the international system has not. [...]From an international relations perspective, the question is how the emergence of the sovereign, territorial state has altered international conduct, not how the role of government has changed. [Spruyt, 1994, p. 189]

Seen from this theoretical realist perspective, the proliferation of international organisations and regimes, which are state-created and depend on state co-operation [whether voluntary or deliberate or other], represents an extension of the state. To what extent then, do an organisational body such as the [WTO AB] and practises established by the NAFTA, follow in the logic of the state-based international regimes?

In the context of this paper, it suffices to mention that the substance of lex mercatoria (i.e., merchant law) benefits from two worlds: Public and private international law on the one hand, and the commercial "code" created by such agencies as the International Chamber of Commerce [ICC], on the other hand.[9] My interest here is to ascertain the degree to which the international legislative process of developing the lex mercatoria nourishes the ADR regime of trade liberalisation with new international legal substance.[10]

Institutionalization of the WTO AB and the NAFTA Ch. 11 ADR mechanism: Do they satisfy the legitimacy requirements of fairness?

Organization-building

Institutionalization by way of organisation-building traces a rich history. The abundant literature on international organisations, e.g. the Bretton Woods and others [regional and international], serves to illustrate that such bodies have over time evolved to address, regulate, and harmonise international commercial activity, whether practised by states only or by non-state actors. In the area of private foreign investment, international organisations have played an important role in adopting, and consequently participating, in the legitimisation of extra-judicial practises [even if these practises were originally intended to facilitate negotiations rather than arbiter disputes]. [Jackson, 2000, p. 68] Indeed, "one of the interesting and certainly more controversial aspects of GATT as an institution was its dispute settlement mechanism. […] and some could argue that in fact they [procedures] worked better than those of the World Court and many other international dispute procedures." [Jackson, 2000, p. 68] The WTO followed suit with the Dispute Settlement Understanding [DSU] for intellectual property and service trade interests.[11] The NAFTA, which is an agreement establishing a free trade regime, devoid of any central institutional structure, carried the process an extra step further by inviting a distinct private legal person, namely the investor, to become a recognised and equal subject in the process.

Institutionalisation as organisation-building is [indirectly] addressed by Hertz [1997] who comments on the weakness of the International Court of Justice [ICJ] in matters intellectual property rights [IPRs] dispute settlement. I take Hertz' analysis as an example which can be applied to any other field of international public law. Although the main IPRs conventions provide for the filing of disputes with the ICJ, the statute of which is an integral part of the United Nations Charter; and although the United Nations is an inter-governmental state-based organisation par excellence, "the Court has never been used to litigate an IP case for reasons which are not entirely clear."[12] [p. 269]

However, if measured against the legitimacy requirements of the fairness test, the ICJ, which is tailored according to the raison d'État of state sovereignty, represents a model which is closest to the domestic judiciary state authority. It is reasonable to expect that determinacy, i.e. clarity and transparency in the language of the law, is satisfied thanks to the judges' professionalism in rendering adjudicative decisions. Symbolic validation, i.e. reinforcement of legitimacy by signalling that authority is institutionally recognised and confirmed, almost automatically emanates from the fact that the decisions are rendered by judges recognised as the highest judicial authority available, not only domestically but also internationally. It is the ICJ's

"[constitutional incapability] of laying down positively how a treaty is to be performed" [Rosenne in Hertz, 1997, p. 272, my emphasis]. This incapability derogates not of the ICJ's legitimacy, but of its competency and consequently, practicality.[13]

Recourse to the ICJ arises when domestic processes and/or remedies are unavailable or undesirable.[14] Consequently, commensurate to the rate of governments' avoidance of ICJ adjudicative services, has been the recourse to substitutes, e.g. GATT-style followed by WTO DSU, or NAFTA ADR mechanisms. These mechanisms appear strong in satisfying the substantive - distributive justice - leg of the fairness test.[15] Corrective equity, i.e. to correct a rule which is too conservative or rigid to be applied without risking killing its spirit, is made available by flexible compromise-seeking arbitral awards. Broadly conceived equity, where equity itself is a rule of law pertaining to resource allocation, is presumed to be warranted by the logic of the consensual underpinnings of alternative dispute resolution. Common heritage equity, which assumes that certain resources, for instance the right of authoritatively sanctioned retaliation for injustice, is shared equally by all humanity. Therefore, the GATT-style dispute settlement, followed by the WTO DSU, and by the NAFTA ADR, of ordering withdrawal of non-conforming domestic law or practise [Hertz, 1997, p. 273] is a more viable and effective law enforcement option than any ICJ judgement. It also has the appearance [contributing to a sense of legitimacy] of being a preferable solution to self-help. [Hertz, 1997, p. 274]

So, while the ICJ is seen as strong in legitimacy and weak in distributive justice, international ADR mechanisms, which appear to be strong in substance, are weak in legitimacy, i.e. procedural fairness. Faced with the inability to satisfy both aspects of fairness, the international community of states has opted for the latter. However, the practical and expedient preference of effectiveness[16] is intrinsically vitiated by the shaky foundation on which it rests. By placing the WTO AB as an authority of appeal from the DSU panels, and by declaring its decisions as final, the DSU created a legal androgynous of an ADR mechanism cum court of justice competence. Created by a process and guided by a logic unlike those leading to the establishment of a court of justice, the WTO AB has been empowered in certain aspects with competences that equal those of a court of justice. Such inconsistencies should not be considered a source of "law"; cannot be a source of justice. The NAFTA provisions do not even come close to the justice-appearance of the WTO AB.

Cognisant of the paradox, the government of Canada identified several WTO DSU key issues requiring improvement. In its communiqués, it does not neglect to mention the sources of its findings as "based on dispute settlement experience and the advice of Canadians" [Update, 1/3, my emphasis]. Among the issues identified, improvements designed to enhance efficiency in the dispute settlement process, panel professionalism, and transparencies are pertinent. The efficiency of the DSU, for instance, is compromised where the AB has refused to rule on certain issues due to absence on the record of sufficient findings by the panel. This may leave a complainant without a resolution of the dispute, and necessitate the commencing of an entirely new set of proceedings. "Canada therefore supports proposed amendments to the DSU that would provide the Appellate Body with the authority to refer factual or legal issues back to the original panel to address issues not covered earlier or to re-examine factual findings." [Update, Jan 3/3]. Presumably, borrowing more from the national court practise, here - the re-trial, is considered a means to overcome the legal conundrum arising from the finality of the arbitration award. For that purpose, and to insure the cohesion and teleology of the suggestions for improvements, enhanced professionalism - of the panellists, not the AB members - is vital.

"Canada agrees with many of the observations made by the European Communities […], including the […] insufficient number of qualified panellists. […] Panellists are to be selected with a view to ensuring the independence of those serving on a panel, a sufficiently diverse background and wide spectrum of experience. […]

[T]he qualifications for panellists should be no less stringent than those for Appellate Body Members." [Consultation, 3-4/16][17]

Finally, transparency is perceived as a requisite to "reinforce the legitimacy of WTO dispute settlement". [Consultation 5/16] Again, in a move that appears to bring the WTO DSU closer to an administrative tribunal, and furthermore, elevate the AB closer to the traditional court level, Canada argues that unlike other ADR mechanisms [e.g. consultation, good offices, conciliation, and mediation].

"[…] the rationale for keeping consultations confidential does not apply to panel or Appellate Body proceedings. Members do not engage in negotiations at panel and Appellate Body meetings. Likewise, Members do not negotiate with one another through their written submissions to panels and the Appellate Body". [Consultation, 6/16].

Although the NAFTA ADR mechanism shares similarities with the WTO DSU, a significant departure from international practise - the de facto recognition of the status of subject of international law for the non-state actor [investor; with precedents in bilateral investment treaties] - introduces a NAFTA specific ADR problematic. Here, the government of Canada is more reserved. While recognising the need to further develop Ch. 11, it does not yet make any organisation-building proposals. [Notes] For the time being, the NAFTA Ch. 11 "irregularities" have been addressed by

The NAFTA Free Trade Commission [which] took the unprecedented step of issuing a joint interpretive statement aimed at clarifying key aspects of the process for the purposes of future arbitrations. This statement effectively endorsed two key aspects of Justice Tysoe's [in Metalcald[18]] ruling with respect to the ambit of Article 1105. It also committed the NAFTA Parties to taking greater steps to share documents filed in connection with Chapter Eleven proceedings with members of the public and other levels of government, in the hope that, as the U.S. Trade Representative put it, 'sunshine [will] overcome some of [the] fears and concerns' created by the procedure." [Tollefson, 2002, p. 186].

In his work on systems of control in international adjudication and arbitration, Reisman [1992] points to a current factual departure of the previously maintained sharp distinction between inter-state public international tribunals on the one hand, and inter-non-state-entities international commercial tribunals on the other hand. "The great public international tribunals have often served as models for private developments and vice versa. Thus, there has been a certain amount of interstimulaton in which the experiences of one are shared and sometimes transferred to another." [p. 29] This observation applies to the organisation-building aspect of legitimacy, e.g. the WTO AB's emulation of an appeal court mechanism discussed above. It applies also to the regime building facet of legitimacy, namely the rule interpreting, and hence indirect rule making, role of judiciary bodies, discussed next.

Regime building

International courts as well as international commercial arbitration tribunals are not institutionally required to cite or to found their awards in their previous or other tribunals' holdings. Thus, their awards do not fall within the doctrine of stare decisis governing national judiciary bodies. In fact, however, to secure consistent interpretation of the law, the legal precedent by definition, "performs a special, if latent control function in international adjudication." [Riesman, 1992, p. 31, my emphasis].[19] Bjorklund [2001] [suggests that while not binding, decisions by the NAFTA tribunals "may be viewed as persuasive authority by subsequent tribunals."], [p. 186] Laird [2001] is more explicit in his reference to stare decisis in arbitration: "[I]nvestment treaties, such as Bilateral Investment Treaties […] include rather arcane substantive trade provisions developed over a hundred years of international arbitration." [p. 224, my emphasis]. In other words, the legitimacy of a justice system is rooted in the predictability of the court's or tribunal's behaviour. Such predictability is best served by two of the components of the legitimacy leg of the fairness test. Coherence represents the generality of the rule by evidencing a principled approach [sometimes inconsistent but never capricious], and explaining why a rule compels. Adherence assures the connection between primary and secondary rules, the jus cogens of "peremptory norms" where rules are validated or invalidated by other rules. "This problem appears to be bedevilling […] certain international commercial tribunals with regard to party-designated law, the latter through the device of the so-called lex mercatoria." [Riesman, 1992, p. 34].

I will explore later[20] the extent to which awards rendered by the WTO AB and the NAFTA tribunals operate as de facto, although not de jure, sources of international law - in part, because they are founded in lex mercatoria. Here, I am addressing only one aspect of the arbitral tribunal-generated stare decisis. I am focusing on arbitral jurisdiction and on the process of judicial oversight, i.e. the position taken by domestic courts to which arbitral awards are appealed for want of arbitration tribunal jurisdiction. Another aspect played by the national court deals with the court's interpretation of the award.[21] To be sure, these two aspects are not independent; in fact, they spill over one into the other.

An arbitrator's source of adjudication is derived from the contract between the private parties and limits the arbitrator to do only that which is authorised by the parties: arbiter nihil extra compromissum facere potest. [Riesman, 1992, p. 6] Whereas the GATT/WTO dispute resolution mechanisms have preserved this principle as governing their state-to-state disputes,[22] the NAFTA has introduced the "practice" of "arbitration without privity". In this arrangement, the state sets the terms governing the claimant, which is not party to the agreement. [Bjorklund, p. 1] This arbitral jurisdiction power has its source in the law governing international commercial disputes. According to one argument, Ch. 11 represents the latest development in an "international legislative" process beginning in the late 19th and early 20th centuries with the use of mixed claims commissions, and continuing in the 1980s with the protection of foreign investors through bilateral investment treaties [BITs]. [Bjorklund, 2001, p. 185]. Both practises vary in their characteristics from Ch. 11, and there is little to learn from BIT disputes which remain confidential. [Bjorklund, pp. 186-187]. The extent to which these practices can be considered as primary sources underpinning Ch. 11 is therefore unclear. Furthermore, in the hybrid case of Ch. 11, which provides for a state-to-private-party dispute resolution mechanism - should arbitration be governed by NAFTA law or by lex arbitri as is the case in the context of state-to-state trade disputes? [Tollefson, 2002, pp. 229-230]. Of vital importance - for to date most Ch. 11 cases have raised at least some sort of jurisdictional objection - a clarification of this dilemma will require addressing also the legal principles created by the jurisprudence of lex mercatoria.[23]

On the issue of judicial oversight, the output of NAFTA Ch. 11 arbitral awards, one of which had been adjudicated by a Canadian national court [Metalclad], suggests, largely but not exclusively, a pattern of court deference to tribunal's jurisdiction, i.e. of findings that the tribunal did not exceed its jurisdiction. In the benchmark Metalclad judgment, Justice Tysoe's sends a message to courts to keep out of the "other" justice system, namely the arbitral one founded in a separate teleology of justice. Although Tollefson [2002] marks the decision as characteristic of a pattern of very "cautious […decisions] that approach[es] the task of reviewing the award deferentially", an approach typical to arbitral-awards-reviewing-courts, [p. 221], this in itself would have been insufficient to evidence such pattern. However, where a court makes such decision, and the foundations for the judiciary's deferred position remain unknown, it may logically follow that, perhaps by default; the judiciary is granting allowance to arbitral tribunals to develop new international law. This constitutes yet another piece in the larger jigsaw puzzle of the perforation of public international law by private international law.

In Metalclad, Mexico, supported by the Intervenor Attorney General of Canada, urged the Court to review the traditional judicial deferential approach to private commercial arbitral awards because Ch. 11 represented a departure from that type of disputes. Linking arbitration without privity to judicial deference it maintained that, unlike GATT/WTO disputes, Ch. 11 involved non-parties to the contract [treaty], i.e. the investor in this case. Indeed, Ch. 11 transposes "arbitration rules [that] were created to remove investment disputes from the heated political arena of state-to-state controversy to the cooler […] tribunal," [Laird, 2001, p. 225], to investor/private-party-to-state disputes, however without neither legal nor political explanation hence without justification.[24] It also raised issues of public concern and the public good [Tollefson, 2002, p. 204]. In avoiding addressing the argument, the Court practically rejected it.

Another (partial) NAFTA award from 2000, is S.D. Myers. v. Government of Canada [S.D. Myers] also gave rise to a similar consideration of arbitral jurisdiction. In the absence of NAFTA guidelines on compensation, the tribunal turned to international law. However, since an arbitration tribunal is restricted to interpret the "contract", dito the NAFTA treaty only, and not decide on issues which are outside the realm of the "contract", Canada asked the Federal Court to set aside the award based on jurisdictional excess and conflict with Canada's public policy [Canada Seeks].

Conclusion

In this paper, I examined part of the role of institutionalisation in legitimising the legal status of international commercial arbitration. I used Thomas' [1995] characterization of legitimacy which embodies the procedural component of justice. I distinguished two main processes typical of institutionalisation: Organisation- building and regime-building. I used the four legs of the legitimacy test to explore whether organisation-building and regime-building as developing in international commercial arbitration in the WTO DSU and NAFTA Ch. 11 ADR provisions, pass that part of the fairness test.

My study shows that the WTO AB, with final jurisdiction, largely emulates the characteristics of a national court of appeal instance, although the legal foundations of the WTO AB do not support endowment with such competencies. The improvements suggested by the EU and the government of Canada lend further reinforcement to this observation. The WTO AB therefore fails to conform with the procedural component of fairness although, on its' face, it appears to satisfy the substantive one. This part of the legitimacy test of institutionalism does not apply to the NAFTA Ch. 11 ADR mechanism, which is still too remote from any stage of organisation-building.

An examination of the role played by the WTO AB and NAFTA Ch. 11 in international commercial arbitration regime-building also reveals an aberration from the presumed legitimatising authority imputed to this quasi-legislative process. As NAFTA arbitral procedures and awards show, much revolves around the question of the jurisdiction of the arbitration tribunal. The only judicial oversight exercised so far in Ch. 11 matters was clearly deferential of the tribunal [Metalcald]. As a final appeal instance, and given the limited jurisdiction of the ICJ, the WTO AB is free of such oversight. Future analysis of NAFTA arbitration tribunals and WTO AB awards, and where applicable, court's [and also academic] interpretations of such awards, will allow to establish whether the absence of judicial oversight does indeed facilitate, by default, the turning of such awards into de facto stare decisis. Law interpretation being the purview of courts of law - not of a private party consent based dispute settlement procedure - such examination will shed additional light on the legitimacy, and consequently fairness, of extant international commercial arbitration.

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End Notes

[1] Several sections of this draft paper are adopted either directly and/or with some modification from my paper "Private vs. Public International Justice: The Role of ADR in Global and Regional Economic Treaties", 48pp, *NACS Text Series*, forthcoming end 2003, temporarily available on the Website of the Canadian Swedish Business Association [CSBA], www.csba.nu.

[2] See Harlow on access to justice and the rule of law and on the "relatively high place on the rights agenda for the procedural value of access to justice" [188].

[3] This paper explores the instrumentality of fairness indicators as developed by Thomas M. Franck in *Fairness in International Law and Institutions* [Oxford: Clarendon Press, 1995] to the issue of access to justice.

[4] A term that Franck borrows from Rawls [9].

[5] See Maduro addressing the "what is" vs. "what should be", but not the "how", questions of the constitutional analysis of fair vs. free trade.

[6] Since my data collection and processing are still incomplete and therefore do not yet permit an exhaustive analysis of all the indicators, any conclusion must be considered temporary and partial.

[7] Three components are necessary to re-institutionalise conflict management: Well-defined general procedures of conflict management, reliable expectations based on well-defined actors and reciprocity, and typifying of the conflict according to types of actors. [Siedschlag in Gal-Or]. These conditions [which correspond with parts of the fairness test] have only partly materialised in the GATT/WTO and the NAFTA.

[8] Of course, irreversibility of a certain institution lasts as long as the next revolutionary change.

[9] Mistelis refers to this as international legislation and international commercial custom, respectively. [13]. However, "international commercial custom" must not be confused with international customary law, which is a source of law of Westphalian statist foundations.

[10] I will discuss the meaning of constitutionalism in the context of dispute resolution in liberalised trade regimes in a later paper. For the time being, it suffices to note that constitutionalisation is the legal twin sibling of political institutionalisation. It reflects the establishment of a new meaning and substance to existing and/or newly formed values by the eternalisation of core values. Cass lists various meanings of constitutionalism evidenced, for instance, when some issues of international trade become firmly incorporated within national legal systems; when questions of legitimacy are involved; when a custom originating in a base is emerging; or, as Cass prefers to understand it - when there is "constitution-making by judicial interpretation." [3-5, note 3] For a most recent stage in the debate on constitutionalism see Petersmann; Howse; Alston, Maduro.

[11] In the EU as well, the law of commercial dispute resolution strikes out as an exception to the plurality and incongruity of authority [national, subnational, and supranational] in various other EU domains. For instance, the EU authorities do have exclusive competence, aided by the European Court of Justice [ECJ], in the area of competition policy. [Schmitter 239]

[12] I contend in mentioning here that the limited jurisdiction of the ICJ to order certain remedies also figures among these reasons. For lack of space, I will skip the discussion of these reasons, and will return to it in a more elaborate version of this paper.

[13] Which, of course, affects the distributive justice aspect of fairness.

[14] The latter, among other reasons, for suspicion of discriminatory practises against foreigners by national courts, among other reasons.
[15] Addressing the legislative process [hereafter] emerging from arbitral decisions, will unravel the fallacy of such expectation.
[16] "If the system of international arbitration is to continue to meet the needs of international business, it is necessary to reach a balance between the conflicting goals of justice and finality in commercial arbitration. […] The United Sates depends upon international markets to expand its economy. Accordingly, the possible unfairness inherent in a lack of judicial review is outweighed by the national interest in preserving the independence of international arbitration." [Gelander 627, 642].
[17] See, Contribution from the EC and Its Member States, raising the issues of panelists' expertise, rules of conflict, and particularly the remand procedure – all of which suggest a more litigious band less compromise oriented process hence a shift closer to a court-like situation. For a general legal reasoning of the WTO AB see Behboodi.
[18] Discussed in the next section.
[19] For *stare decisis* in WTO arbitral awards see *supra* note 10.
[20] In the comprehensive study of "Outsourcing Justice".
[21] I am deferring this discourse to the final draft of this paper.
[22] The question of judicial oversight is mute in the case of the WTO for this organization has its own final instance – the WTO AB.
[23] The expedient argument that "Ch. 11 is a new remedy for investors to make claims against governments in their own names, rather than through traditional diplomatic methods and politics" [Laird 224] cannot serve as panacea nor as legal argument to elevate the investor to the status of a subject of international law status.
[24] Again, the argument that Ch. 11 "is a relatively limited, although powerful […], legal remedy" [Laird 226] [limited as to the number of cases arbitrated] - doesn't make it any more or less legitimate. In fact, it lends support to my argument [in previous publications] about both the legal and social unfair nature of Ch. 11, which is discriminatory in its current form.

Legal Principles and Judicial Decisions on Environments in Malaysia: An Overview

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Abstract

The awareness that healthy environment is a necessity to human life, is increasing today. Long time ago, people only tended to lay emphasize on the satisfaction of their basic and personal human rights, which would include foods, lodging, raiment as well as other simple constitutional rights such as freedom of speech etc. But now it evinces that, environmental safety and health right, though at the first glance and at the outset, seems only a peripheral right, it has become overwhelming and expedient to human life, that should be reckoned with. In respect of the law, it is manifestly clear that it could lend its aids protecting mankind against any adverse environmental wrongdoings. These would include providing legal remedies such as injunctions, damages, compensation or even imposition of criminal penalties against the defendants/perpetrators. Hence, this article will look into the law in Malaysia in regard to its ability to provide environmental protection based on the decided cases in courts.

Introduction

Environmental awareness has been quite overwhelmingly an important topic today. This is due to the increasing knowledge among people on the importance of preserving and maintaining healthy environments. Long time ago, in particular on the verge and uprising era of the industrial ages, particularly in the 16^{th}, 17^{th} and 18^{th} centuries, people tended and revolved to lay emphasize on the maximization of profits through the mass production of products and services in the course of industrial revolution, which were achieved to certain extent, flippantly nor callously, to the detriment of the environment. But nowadays, healthy and safe environment becomes indispensably and overridingly essential to ensure the survival of mankind, without which, our surroundings - the earth, air, waters and lands which we live on would be hazardous, dangerous to health and life itself. Examples of environmental catastrophes which are evident till today include - the poison gas incident at Bhopal, India (1983); the problems caused by contaminated land at Love Canal, USA (1978); the disaster at Chernobyl (1986); the UK Braser oil tanker disaster in 1993, the effects of which are still with us today. These catastrophes are also grim reminders that the exercise of enough care in protecting environments is vitally important.

Thus on this footing, there arose the awareness of the importance of its sustainability and longevity, thus ensuing the necessity of providing rules and regulations governing the conducts and policy with view to control and govern the environments. In this regard, it is found that, the law has since its birth and evolution recognized acts and conducts of man which could possibly affect environments and attempts to control and govern them. This law was formerly and still hitherto known as law of torts. This branch of law mainly concerns the identification of wrongful acts and provides remedies, penalties and judicial redresses to compensate and protect the aggrieved parties'/claimants'/plaintiffs' rights against adverse environmental acts by others. Instances of the category of this principles of law are, the law relating to nuisance and negligence and the rule under Rylands v. Flether, which emphasize on the importance of observing and respecting others' right and enjoyment against any interference, disturbance and wreaking havoc. These are amongst the principles adopted by law in the attempt to govern and control the effect of environmental hazards.

Further, to consolidate and improvise the existing law – the common law or the unwritten laws, some government had embarked into introducing statutory provisions in regard to maintaining, governing and controlling the standard practice of people who could affect the environments. For instance, in Malaysia, these provisions contained in the Environmental Quality Act 1974(EQA) and its regulations made there under. Apart from these statutory provisions, the English common law is also applicable in dealing with environmental issues and matters, via its law of torts or in certain extent the law of contract.

Definition of Environment

In so far as Malaysia is concerned, there is no judicial definition on the meaning of 'environment'. However, this word has been defined by statutes. Thus, pursuant to section 2 of the Environmental Quality Act 1974, 'environment' means:

> 'the physical factors of the surroundings of the human beings including land, water, atmosphere, climate, sound, odor, taste, the biological factors of animals and plants and the social factor of aesthetics'

Based on this statutory definition, environment would, it is submitted, to mean 'all physical matters that surround us (mankind)'. These would of course include water and air, land etc. What concerns environmental law is how could government or we as the general public exercise control over these matters (environments) to ensure its safety and health.[1] Other alternative definition, which we could refer, is the UK statutory definition. Accordingly, pursuant to section 1(2) of the UK Environmental Protection Act 1990 defines 'environment' as:

> '…consists of all, or any of the following media, namely, the air, water and land; and the medium of air includes the air within buildings and the air within other natural or man-made structures above or below ground.'

This is clearly a very wide definition which encompass environmental challenges ranging from ecological problems, such as damage to natural habitat and the conservation of flora and fauna, the 'working environment' with problems such as 'sick building syndrome' and more obvious problems such as noxious emissions into the atmosphere.[2]

Objectives

This paper is to elaborate the law in regard to environmental issues and protection, particularly on the decided cases in Malaysia which are based on several causes of action and legal principles as provided by law of torts and environmental statutory provisions. Via these disclosures, they would able to illuminate as well as to underscore us the legal positions and rights and remedies affordable and espoused by law as practice in Malaysia, in the course of its environmental protection.

Approach

This paper will only touch on the decided cases in Malaysia as far as its relate to environmental protection. Thus, the provisions as contained in the Environmental Quality Act 1974('EQA 1974') and its regulations made there under would not be touched except on some respects insofar as it has been dealt with by cases decided in courts. This paper will highlight such cases based on the below sub-headings.

1) The cause of action based on nuisance, negligence and under the rule under Rylands v. Fletcher;
2) The new thought on cause of action based on recent English and foreign cases; and,
3) Cases Emanate From EQA 1974.

1) The Cause of Action based on Nuisance, Negligence and the Rule under Rylands v. Fletcher[3]

The aggrieved party/plaintiff/claimant to these tortuous acts may commence action in court against the party who has committed these tortuous acts and thereby caused damages, sufferings and losses to him. Usually, the remedies that are available and imperative for him are damages, restitutions, abatement (a summary remedy which was only justified in clear and simple cases)[4] or an for an order of injunction restraining the defendants from further committing these actionable acts. The following elaborations will highlight in detail the operations of these causes of actions and supported by cases, hitherto been decided in Malaysia.

a) Nuisance

Nuisance is 'an act or omission which is an interference with, disturbance of or annoyance to, a person in the exercise or enjoyment of (a) a right belonging to him as a member of the public, when it is a public nuisance, or (b) his ownership or occupation of land or of some easement, profit, or other rights used or enjoyed in connection with land, when it is a private nuisance'[5]. In environmental law, this cause of action can be invoked to protect or preserve the status quo of the ownership or occupation or enjoyment of land or interest belonging to the aggrieved party/plaintiff/claimant. For example, floods, excess soils, fumes, leakages of poisonous, chemical and radioactive hazardous substances or smokes or others act or causes, created or caused by or due to one's unreasonable interferences and disturbances, either he done it advertent or inadvertently, detrimental to the other who might reasonably could have been affected or suffered by his acts. In this action, courts in Malaysia, would follow and apply the law of nuisance and principles as practices in England subject to the permission given by the Civil Law Act 1956.

The instance of the case that falls under this heading is Chan Jen Chiat v. Allied Granite Marble Industries Sdn. Bhd[6]. In this case, the plaintiff, a tenant occupying a piece of leased land whose activities' were subject to the express condition that the land used was for horticulture and fishery. On this, ponds were constructed and parts of them were used to breed worms as feed meals for his fishes. Adjacent to his land, was the defendant, carrying on business of earthworks which included leveling of land for the construction a factory to be built on it. The defendant's land also was a leased land. The plaintiff's ponds were filled by water supplied flown from drains running through and across the defendant's land. However later, the defendant altered the drains by constructing a culvert. He did this with the view to prevent any excess soils resulting from the earthworks' undertaken from flowing into the plaintiff's ponds. However, it was found that, due to heavy rainfalls, the drains were not suitable and insufficient to carry away the water and soils into the river. Thus, inadvertently, these excess soils eventually flew into the plaintiff's ponds, killing all the worms. The plaintiff suffered losses due to this interference. After several requests by the plaintiff to the defendant to restore and rectified this catastrophe proved futile, the plaintiff took an action against the defendant, the prayers *inter alia* included an order for mandatory injunction to compel the defendant to repair the drains so as make it good enough to flow and channel the excess soils resulted from the carrying out of the earthworks by the defendant and so they would not spill over and flow into the plaintiff's ponds.

In the judgment of this case, the issue of suitability of granting mandatory injunction was highlighted by the trial judge. According to the judge the plaintiff was entitled to mandatory injunction to compel the defendant to repair and provide suitable and sufficient culvert and drains so as to be capable of carrying and channeling these water and excess soils to proper place. Otherwise, the plaintiff would suffer irreparable damages and injury. On this the judge referred to the principles of law in Wah Loong (Jelapang) Tin Mine Sdn. Bhd v Chia Ngen Yiok[7] and Hubbard v. Vosper.[8]

Apart from the above contention by the plaintiff, the plaintiff also had successfully convinced the court that the acts of the defendant were nuisance in that the acts had created a dangerous situation and unnatural use of the land and finally it ensued that the defendant would have known and ought to have known that, by his very acts, they would likely to affect and block the natural flow of water and excess soils, which the drains and culverts could bare and due to this unbearable circumstances, excess waters and soils would have flown into the plaintiff's ponds thus resulting in actionable nuisance. Similar principles were adopted in Seong Fatt Sawmills Sdn. Bhd v. Dunlop Malaysia Industries Sdn. Bhd[9], Toyo Textiles Industries Sdn. Bhd & Anor v.Lian Foong Housing Development (M) Sdn. Bhd.[10] (the defendant blocked the natural stream causing waters flowing into the plaintiff's), Pacific Engineering Limited v. Haji Ahmad Rice Mill Ltd[11](spreaded smoke, ash, rice husks and dust caused by the defendant's business to the detriment of the plaintiff's comfort and convenience of life), Wu Siew Ying v. Gunung Tunggal Quarry & Construction Sdn. Bhd. & Ors[12] (where the defendant as a quarry operator was held liable for nuisance as he failed to take sufficient precaution during the course of extracting limestone of the hills which due to their failure, had caused the limestone rock debris fallen onto the plaintiff's land and destroyed the plaintiff's nursery) and Ng Chen Kee & Ors v. Loh Peng Kung & Anor[13](the defendant had caused nuisance against the plaintiff in that he had wantonly created a drain which resulted excess waters to have escaped into the plaintiff's paddy and destroyed them).

In this case too, apart from the wrongful conduct of the defendant in tort, the defendant also had failed to obtain necessary approval, required by section 70A(1) of the Street, Drainage and Building Act 1974, from the local authority before commencing the earthworks activities. In addition to the grant of injunction and further orders compelling the defendant to repair the drains, the court also allowed application for damages by the plaintiff.

b) Negligence

In an action on the ground of negligence, there are four requirements that need to be met by the aggrieved party/plaintiff/claimant to prove the liability of the defendant. These requirements are:

1) the existence in law of duty of care situation, on part of the defendant, ie one in which the law attaches liability to carelessness…;
2) breach of the duty of care by the defendant, ie that it failed to measure up to the standard set by law;
3) that the particular kind of damage to the particular claimant is not so unforeseeable as to be too remote.[14]

Under this sub heading, the claimant has to prove the existence of duty of care owed by the defendant who has, actually fails to exercise it and causes damages and losses to the claimant. The duty of care is determined by express or implied agreement that certain duty of care is required by the law, to have been reasonably exercised by the defendant. And because of this agreement, the claimant relies on such agreement and assured that the defendant would so exercise such duty of care. Further, the claimant must prove that the losses or damages he suffered must have been the outright result from the breach of such duty of care by the defendant.

The example of decided cases, in this respect, is Mc Gowan & Anor v. Wong Shee Fun & Anor[15]. In this case, the plaintiff was the occupier of a piece of land adjacent to a river. Up north of the river were lands occupied by the defendants. The first defendant had constructed a culvert to cope with the running rain water, whilst the second defendant was at all material times a developer carrying out their housing development projects beside the river. The plaintiff alleged that due to heavy rainfalls, soils were stripped off and excess waters were and could not properly channeled into the river as the culvert were not adequate enough to cope with the sudden spate caused. The matters were even worse when the culvert were blocked by fine earth, silt and partly by the branches of trees and other debris. These blocking materials were found to have carried away by the waters from the second defendant's land. This fine earth, silt, soils and excess water, which should have been flown throughout the river, but due to the blocking culvert, caused damage to the plaintiff's property. The court held that both defendants had caused nuisance and had negligently caused such trouble to the detriment of the plaintiff's property. The defendants were negligent in stripping off the top soil of their respective lands without taking all reasonable steps to prevent fine earth from being washed down the sides of the slopes into the stream and the second defendant was negligent in allowing debris and pieces of timber to be washed down into the stream. In the result, the court granted damages, to be equally apportioned between the two defendants, to the plaintiff.

Instances of other cases are:

1)Parimala a/p Muthusamay & Ors v Projek Lebuhraya Utara-Selatan[16]. In this case, the plaintiffs were passengers in a motorcar driven by the deceased which was traveling through the north bound lane towards Ayer Keroh, Melaka at the time of the accident. The deceased died on the spot after hitting a stray cow which had found its way, gained access through broken fences, to the highway. The defendant was the highway authority responsible for the construction, maintenance, management and safety of the North-South Highway, a line of highway constructed throughout the Peninsular Malaysia. The plaintiff's claim was for breach of duty of care on the part of the defendant as against the plaintiff who were users of the highway. The plaintiffs based their claim against the defendant, *inter alia*, on the common law negligence. The court found that the defendant had been negligence in failing to ensure that the cows did not entered into the highways, which resulted the accident and death to the highway's users; and,

2) Goh Chat Ngee & Ors v. Toh Yan & Anor[17], where the court found that apart from nuisance, the defendant also was in negligence in that the defendant – a mining operator, as the owner of the adjacent land to the plaintiff's failed to maintain support for his neighbor's land, but instead he had done such as in

this case which had caused the soil structure of the plaintiff's disturbed, flooded and collapsed, causing damages and sufferings to the plaintiff.

c) The Rule Under Rylands & Anor. v Fletcher[18]

The principles of the rule were established in the judgment delivered by Blackburn J in the case of Rylands v. Fletcher. According to the court, commenting on this rule of law, that:

> 'We think that the true rule of law is, that the person who for his own purposes brings on his lands and collects and keeps there anything likely to do mischief if it escapes, must keep it in at his peril, and, if he does not do so, is prima facie answerable for all the damages which is the natural consequences of its escape'

Based on this ratio, whosoever causes 'mischief', in so far the mischief is due to his failure to reasonably keep things that would likely to cause mischief if it escapes, against other people who is or would be likely become the victim or foreseeably would be effected by his very act of letting the things out causing the 'mischief', he must be held liable to damages suffered by claimant. It is submitted that that things would include for example, oils, explosions, noxious fumes, poisons, radioactive substances or even wild animals. Thus, such person in possession of such thing which may cause 'mischief', must exercise greater care so as to protect nor to preserve these things from causing 'trouble' to others.

The application of the above principle can be seen in several cases in Malaysia. One of them is Dato' Dr. Harnam Singh Practicing As Harnam Ent Hospital And/Or Dato' (Dr) Harnam's ears, Nose and Throat Specialist Clinic Sdn. Bhd v. Renal Link (KL) Sdn. Bhd.[19] In the case the plaintiff alleged that the defendant was guilty of nuisance in that they - the defendant had emitted over the plaintiff's premises noxious and offensive fumes, vapors, gases, chemicals, smells and toxic materials which have caused the plaintiff to suffer injuries. The plaintiff also proceeded on the Rylands v. Fletcher's principle alleging:

- ?? that the defendant is bringing and storing in their premises noxious and offensive materials;
- ?? that this amounted to a non-natural user of the land;
- ?? that these noxious and offensive substances escaped onto the plaintiff's premises; and,
- ?? that these substances caused annoyance, discomfort, sickness and injury to the plaintiff.

The court found that, on the balance of probabilities, the plaintiff has proved firstly that the defendant's clinic was/is emitting noxious and toxic fumes, gases and chemical smells; secondly, that the said contaminants were escaping from the defendant's premises and getting into the plaintiff's premises; and thirdly, that the said contaminants were causing harm to the plaintiff in that he was unable to use and enjoy the premises. As such the defendant is held liable in nuisance as well as for negligence under the rule of Rylands v. Fletcher. As to negligence under the rule under Rylands v. Fletcher, the court was satisfied from the evidence adduced by the plaintiff that he had proved all the ingredients required to be proven under the said rule, firstly that the defendant had brought, stored and used at first formalin(formaldehyde) and then renalin (acetic acid) in their premises; secondly, that noxious gases were produced; thirdly, that the said gases escaped into plaintiff's premises and lastly, the said gases caused injury to plaintiff's health. In the result, the court awarded damages to the plaintiff for the daily and long suffering the plaintiff has endured since the time he was affected by the act of the defendant. Further, injunction also was issued by the court to restrain the defendant, by their servants or agents or otherwise from continuing the nuisance.

Apart from the above case, amongst other cases that followed the principles adopted the rule under Rylands v. Fletcher are:

1) Ling Nam Rubber Works v. Leong Bee & Company[20] (the plaintiff alleged that the defendant had negligently failed to exercise sufficient and reasonable degree of duty of care in carrying out the substantial earthworks on piece of land, adjacent to the plaintiff's, which due to this negligent had created dangerous situation, where this had allowed rain water to overflow into the plaintiff's land causing extensive damages to the plaintiff's lands, roads, buildings and goods stored therein); and,
2) Dr Abdul Hamid Abdul Rashid & Anor v. Jurusan Malaysia Consultants (sued as a firm) & ors [21] (the plaintiff alleged that third defendant had breached its duty of care towards the plaintiffs in respect of negligence, causing nuisance and liable in part under the rule of Rylands v Fletcher. The third defendant was the contractor engaged in erecting a double storey bungalow on a neighboring land. The third

defendant was said to have unnecessarily allowed infiltration or seepage of water into the land owned by the plaintiff and/or allowing it to overflow onto the plaintiff's land causing saturation in the soil resulting in landslide which brought down the plaintiff's house. The third defendant had artificially accumulated the rainwater with the excavation which was an alteration to the nature of the land and had also interfered with the rainwater by constructing transverse drains ending three quarters down the slope of land adjacent to the plaintiff's land. All these had affected the natural flow of the water resulting in its concentrated and increased infiltration into the land thereby causing destructive effect to the plaintiff's land. The court agreed with the plaintiff's contention).

2) The New Thought on Cause of Action in Environmental Matters

According to one legal practitioner in Malaysia[22], environmental cases can also be brought to court based on, apart from the above traditional cause of actions, the following rules, *viz* 1) The rule in Cambridge Water Company and; 2) The Lender Liability.

a) The Rule in Cambridge Water Company23

This case lays principle that a person would be liable in tort in the event that he had done certain act, which although he considered it to be perfectly normal and effective yet he would have reasonably foreseen that his very act, such as in this case, by letting a solvent, advertently or inadvertently, to leach into the aquifer, would contaminate the water owned by the other party, which virtually found hazardous or detrimental to party consuming that water.

The facts of this case were that, in September 1976, the Cambridge Water Company bought a piece of land which was formerly used as a paper mill at Sawston, Cambridgeshire, attached to which was a license to abstract water from a borehole on the site. Cambridge Water Company began to abstract the water for public consumption in June 1979. Unknown to the water company was the fact that the water was contaminated by a solvent which had leached into the aquifer from a nearby tannery operated by Easter Counties Leather. The spillages of the solvent occurred regularly between 1950 and 1976, after which the tannery began to operate more efficiently. This contamination was not considered an issue until, in 1976, the EC issued Directive 80/778 relating to the standards of drinking water for human consumption and contained figures relating to the maximum levels of perchloroeghylene which could be present in the water. The water abstracted from the borehole from Eastern Counties Leather was found to exceed these limits and use of the borehole was discontinued. In was originally thought that the action would be brought under WRA 1991; however this proved to be impossible as the pollution pre-dated its enactment. Cambridge Water Company began proceedings against Eastern Counties Leather on the grounds of nuisance, negligence and the rule under Rylands v. Flether. The High Court dismissed the action of the plaintiff on the ground that the defendants (Eastern Counties Leather) could not have foreseen the damage caused to the acquifer arising from their tannery operations. However, this was reversed by the Court of Appeal. But, finally this was over ruled by the House of Lords on the ground that the defendant had not reasonably foresee that their solvent would leached into the aquifer. Thus if the element 'reasonably foreseeable to the possibility of the leaching of solvent could contaminate the water', the defendant would not be appropriate nor just to be held liable. In order to succeed, the plaintiff must prove this test, that the defendant having exercising their act, by which act they considered it to be perfectly normal and effective, would have reasonably foreseen that their very act, *viz* by letting the solvent, advertently or inadvertently, to leach into the aquifer, would contaminated the water. Thus the defendant was held not liable. The rule under Rylands v. Fletcher and action on nuisance is qualified by this new 'principle'.

b) The Lender Liability24

This case points out that if the lender/charger/mortgagor of the land or property under a mortgage or charge, knew at the outset, before the prospective buyer came to bid the property, that the said property would not fit for human habitation, yet persuaded the buyer to proceed on to so buying the property, the lender would be liable in tort, if later found that the property, occupied by the buyer to be so defective.

This was the finding in Karoutas v Homefed Bank – In this case, a court of appeal case from California held the knowledge of the lender that the house under bid was subject to progressive soil movement, exposing the house to forces and stresses, and this had not been made known or disclose to the prospective bidder and later became the successful buyer on the view that it would distracted the buyer interest on the house, would tantamount to breach of common law duties on part of the lender.

View on the Application of the Above Two New Authorities

However, it is opined that the above new causes of action or authorities, would be contrary to section 3(1)(a) of the Civil Law Act 1956**.** Pursuant to this section, in West Malaysia, the law that shall be applied are the written laws in force in Malaysia except where there is none, then the common law of England and the rules of equity as administered in England as at 7 April 1956. On the other hand, section 3 (1) (b) and (c) provide that in the case of Sabah and Sarawak, apart from common law and rules of equity, the civil courts shall apply, provided that there is no written law, the statutes of general application as administered or in force in England. The application of these sources of law is that, only those practised and applied in England as at 1st December 1951 for Sabah, and as at 12th December 1949 for Sarawak. However, the application of these sources of law is subject to the proviso 'so far only as the circumstances of the States of Malaysia and their respective inhabitants permit and subject to such qualifications as local circumstances render necessary'.

Thus based on the above provisions, the law that would be applicable in the states in the Peninsular Malaysia would be the common law of England and its rules of equity as administered in England at 7th April, 1956. Now, the above new propounded authorities clearly decided and became law after 7th April, 1956, 1st December, 1951 or 12th December, 1949. Hence, it is submitted that by virtue of this provision, they could not become the law in Malaysia.

3) Cases Emanate From EQA 1974

The first and foremost landmark case that has hitherto, in Malaysia, touched on EQA 1974 is Kajing Tubek & 2 Ors v. Ekran Berhad & Ors[25]. In this case, the plaintiffs being the residents in longhouses in the district of Belaga, Sarawak commenced an action against the defendants on the defendants plan to develop a hydroelectric project in their district. The project would involve the creation of a reservoir, construction of dam, the transmission of the generated electric power from Sarawak in East Malaysia by transmissions cables which will be submerged across the South China Sea. The plaintiffs alleged that by the very act, if allowed to proceed, of the defendants, would lead to the destruction of their long houses, ancestral burial sites as well as lands and forests from which they seek shelter, livelihood, food and medicine which have a strong cultural attachment. However, the defendants, alleged by the plaintiffs, had failed to submit a report to the Director General, of Environmental Department. A report required under section 34A of the EQA. This was because the activities which would be undertaken by the defendants fell within the meaning of 'prescribed activities', pursuant to rule 13(b)[26] of the Environmental Quality (Prescribed Activities) (Environmental Impact Assessment) Order 1987. This report should contain an assessment of the impact such activity which is proposed to be carried out will have or is likely to have, on the environment and a proposal of measures that shall be undertaken to prevent, reduce or control any adverse impact on the environment. A detailed EIA prepared by the proponent of the project must be made available to the public. The public are invited to comment on the proposed project to a review panel. This review panel will formulate its recommendation to the Director General for his considerations and decision on its approval.

At the first instance, the High Court judge allowed the application of the plaintiffs on the ground as prayed. However, upon further appeal to the Court of Appeal, the judgment was reserved[27]. The grounds of such reversal *inter alia* are:

1) the power to allow and regulate such a project lay on the State of Sarawak, pursuant to item 2(a) of List II(land) and item 13 of List IIIA(the production, distribution and supply of water power and of electricity generated by water power) of Schedule 9 to the Federal Constitution, not to the Federal Government. The EQA did not apply to the environment that was the subject matter of this case and the plaintiffs had no vested or other interest under the EQA upon the Amendment Order could have any effect; and,
2) The project was subject to the Sarawak Natural Resources Ordinance 1949 not under the EQA. According to this Ordinance, there was no requirement for the plaintiffs to be supplied with copies

of the environmental impact assessment report. As such the plaintiffs had no cause of action in the appeal. Even if section 34A of the EQA applied, the plaintiffs would only be given copies of the report if they had asked for it. There was no accrued right that the report must be distributed to the public without the public asking for it.

Conclusion

Based on the above elaboration, it is clear that, environmental problems can be brought to court of law *via* the remedies and avenues provided by the rules emanate from common law, in Malaysia. These causes of action include the action on nuisance, negligence and Ryland v. Fletcher. However, it is opined that action on trespass may also be invoked. However, there is yet environmental cases, in so far as Malaysia is concerned, that have touched on this respect of law. It is thought that action on trespass may as well be applied in environmental law, in that, commonly action on trespass concern interferences and disturbance on other's land so as to affect the owner's right and enjoyment over or on the land. Trespass on land is the unjustifiable physical interference with land, arising from intentional or negligent entry onto the land. A continuing trespass may be caused by continuing entry onto the land or by allowing physical matter to remain on land. For example, the emission or leakage of poisonous or radioactive substance into other lands, resulting in the damages or losses to the owners of that particular land or his interest on the land. Such owner apart from applying law of nuisance or negligence or rule under Rylands v. Fletcher, may as well, it is opined, could commence an action based on trespass.[28] Commonly, the remedies that normally be given by court, are damages subject to assessment or injunction or abatement.

In regard to the two new remaining foreign rules *viz* the application of Cambrige Water Company and lender liability as suggested by one author, in Malaysia, it is regretted that these principles may not be applicable in Malaysia on the ground that these rules or principles were made after the dateline allowing the importation of English law and principles unto Malaysia pursuant to the provision of the Civil Law Act 1956. In as much as these rules are concerned, it is thought they are persuasive in nature without having any 'binding' effect to the current and subsequent cases tried in Malaysia. Be that as it may, it is thought that the principles adopted in the law of nuisance, negligence and Ryland v.Fletcher can be expanded and developed by judges in Malaysia, without much reliance on 'Cambridge Water Company' and 'lender liability'. Besides, the principles of law of contract may also be invoked to show that the guilty party/defendant is in breach of a contractual duty to exercise certain duty of care as inherently or understandably to have or should have been exercised by him. This can be seen in the Paramila case, where the company of a highway was found to have been in breach of contractual duty, resulting in the death of passengers after hitting cows, in that they failed to ensure the highway was safe for users. This was evident when they failed to keep the highway free from stray cows, having entered into the highway through the broken fences. Further, it is submitted, among the area that the court could look into and expand the boundary of the existing law is on the liability of environmental or planning consultants, such as engineers, town planners, architects and quantity surveyors even as well, to include the Kuala Lumpur City Mayor, known as people who are responsible in planning the growth of the city, in the event, for example the city is flooded after heavy rain falls due to insufficient or defective street, drainage and planning systems or disasters due to other instances such as soil erosions, leakages of poisonous gas, radioactive substances, fumes, contaminated waters etc resulting in the sufferings of the city's citizens such as diseases, cancers, losses and other deformities.

Finally, with the promulgation of EQA 1974, environmental protection in Malaysia would be more guaranteed in that the EQA 1974 and its regulations made there under seem to have provided measures and rules to govern things or matters that would affect environment as a whole.

References

Contact the author for a list of references.

End Notes

[1] Hence in Malaysia, pursuant to section 3(1) of the EQA 1974, the Director General of Environmental Quality, responsible to the Ministry of Health is entrusted list of duties in order to preserve the health and safety of environments in Malaysia. Amongst his duties are responsible for and to co-ordinate all activities relating to the discharge of wastes into the environment and for preventing or controlling pollution and protecting and enhancing the quality of the environment…See section 3(1)(a)-(o) of the EQA 1974.

[2] Susan Wolf &Anna White, *Principles of Environmental Law*, Second Edition, Cavendish Publishing Limited, London, 1997, p. 1.

[3] As Malaysia (then was called Malaya and Borneo) was one of the British territories prior to its independence in 1957, Malaysian courts inherit and apply the English law. This is provided in section 3(1)(a)(b)(c) of the Civil Law Act 1956.

[4] A common example of abatement was given in Smith v. Giddy(1904) in which it was held that the plaintiff was entitled to cut back the overhanging branches of his neighbor's ash and trees which were damaging the growth of his fruit trees. See Wolf, S & White, Anna, *Principles of Environmental Law,* Second Edition, Cavendish Publishing Limited, London, 1997, p 80.

[5]Clerk & Lindsell on Torts, eigteenth edition, The Common Law Library, London, Sweet & Maxwell, 2000, pp 973-974

[6] (1994) 3 MLJ 495.

[7] (1975) 2 MLJ 109

[8] (1972) 2 QB 84.

[9] (1984) 1 MLJ 286

[10] (1986) 1 MLJ 412

[11] (1966) 2 MLj 142

[12](1999) 4 CLJ 339

[13] (1993) 2 AMR 29

[14] Clerk & Lindsell, Torts, The Common Law Library, Eighteen edition, London Sweet & Maxwell, 2000, pp 274-275

[15] (1966) 1MLJ 1.

[16] (1997) 5 MLJ 488.

[17] (1991) 2 CLj 633

[18] (1868) LR 3 HL 330.

[19] (1996) 1 BLJ 477

[20] (1968) 1 LNS 72

[21] (1997) 3 MLJ 546.

[22]Janet Looi, *Environmental Issues: Major Case Law and Environmental Management*, 3 MLJ, 2002, 287, p. 290.

[23] (1994) 1 All ER 53

[24] Janet Looi, *Environmental Issues: Major Case Law and Environmental Management*, 3 MLJ, 2002, 287, p. 292.

[25] (1996) 2 AMR 244.

[26] Dams and hydro-electric power schemes with either or both of the following:

- i) dams over 15 meters high and ancillary structures covering a total area in excess of 40 hectares;
- ii) reservoirs with a surface area in excess of 400 hectares.

[27] Ketua Pengarah Jabatan Alam Sekitar & Anor v. Kajing Tubek & Ors and Other Appeals (1997) 3 MLJ 23.

[28] See also Susan Wolf & Anna White, *Principles of Environmental Law*, Second Edition, Cavendish Publishing Limited, London, 1997, p. 1. pp. 93-99.

Section 10
Marketing, Entrepreneurship and Small Enterprises

Current Trends in Direct Marketing in Slovak Conditions

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Abstract

The paper highlights selected aspects of direct marketing and its utilization in Slovak republic. The stress is on identifying of a broad frame of direct marketing in Slovak conditions and also on factors with strong influence of further development of direct marketing.

Introduction

The importance of direct marketing (DM) and its roles in the Slovak Republic are increasing. For a growing number of Slovak organizations direct marketing gradually is becoming a fully valuable marketing communication and distribution tool. Direct marketing is utilised by organizations, which are continuously planning and implementing DM campaigns; but also by organizations, which are using some of direct marketing tools occasionally and unconsciously. Direct marketing is a suitable marketing tool not only for profit-oriented companies. DM is utilised by non-profit organizations too (organizations of public sector and private organizations of the third sector, e.g. associations, communities, foundations, political parties, churches, public utility services, etc.). Non-profit organizations are using direct marketing for fundraising activities in particular.

Development of DM in Slovak conditions is based on gradual evolution. It is evident that direct marketing in practice was used for long time before developing of theoretical background and principles. Its development is in strong correspondence with development of new communication and distribution technologies and with evolving business environment. Direct marketing has also its own position as a specific approach of a company to customers, based on creation of long-term relationship. The main reason why to use DM in practise is cost management.
Utilisation of DM is bringing for organization positive economic benefits. They can be demonstrated by:

a) Reducing of acquisition costs for a new customer;
b) Increasing of trading volumes;
c) Increasing of a customer life time value;
d) Reducing of inventories costs;
e) Increasing of the sales management process efficiency.

Utilisations of marketing communications and its sub-set direct marketing vary from company to company. It depends mainly on its inner potential – managerial, financial, personnel and on practical skills and knowledge. It is necessary to evaluate the advantages and the disadvantages of DM and implement them into business. DM could be a competitive tool in an increasingly global economy, when the success of any organization will very much depend on understanding the needs of customers. DM offers to organizations also a wide range of innovations, in fact it is a tailor made marketing.

The importance of DM will be permanently increasing because of stronger competitive environment, new distribution and communication channels, identifying of specific, individual wants and needs of existing and potential customers. “Individuality” of DM relies on its main features – transparency, measurability, flexibility, and variability. McCorkell states, there are four building blocks in DM; Targeting - to find out who will be interested; Interaction – information on how the consumer last responded to an offer; Control – was the interaction worthwhile and Continuity – understanding how to build relationships with customers. DM in its very nature is tailor-made marketing. Of course (according to McCorkell) you can’t devise a unique strategy for every customer or prospective customer. But neither does a tailor design a suit for each customer. The tailor merely ensures the basic design is adapted to match the shape, size and taste of the customer. The tailor's efforts are perfectly focused on the individual customer.

DM can be considered as a powerful weapon both of defensive and offensive marketing especially on the market, which is continuously becoming more and more opened and is influenced by process of globalisation. A lot of organizations will gradually change marketing thoughts and recognise that customer is not only source of an immediate profit, but also the source of long-lasting stability on the market. Customers and needs of customers are crucial terms in marketing conception. Customers are deciding on an organization success. Also customers are selecting tools of marketing communication that have their attention. Relationships between a company and its customers rely mostly on customers' own volition. Therefore here is a wide area for DM approach. This approach is supported by development of new distribution, communication and computer technology. Former interpretation of direct marketing was putting the stress on direct sales, DM was considered only as a distribution tool. But now, also in Slovakia, direct marketing is considered as relevant tool of marketing communication. The future of direct marketing is on its complete implementing into marketing programmes and strategies. Its further development is enhanced by integrated database and integrated direct marketing, and of course with integrated marketing. Managing the customer base means that the firm has at least some kind of direct knowledge of how satisfied its customers are. Instead of thinking in anonymous numbers, or market share, management thinks in terms of people with personal reactions and opinions.

Further development of direct marketing in Slovakia will depend on various factors. One of the most important factors is legal environment. Permanent changes in legal environment cannot positively stimulate usage of DM in practice. But if the area for non-ethical and wasting utilisation of direct marketing will be opened, no one will accept any of DM tools. Customers will refuse this approach. Social responsibility of companies that are participating on DM business is enormous. Therefore ethical limits must be "welcomed". Organizations need to be in touch with customers and to find the best way of doing this. Slovaks protect their privacy and organizations should plan and implement marketing strategies carefully. Otherwise negative attitudes to direct marketing will be increasing.

Purpose of marketing communication is not in disturbing of target audience. If proliferation of advertising is noticeable, organizations should find another possibilities how to communicate messages and to influence potential and/or existing customers. In this point is good to start with discussion about the nature of direct marketing and to focus on the emergence of the concept of integrated marketing communications. Integrated marketing communication involves the aim of achieving a greater synergy. The approach of DM to customers differs from mass marketing. It allows using large volumes of customer data to predict their future behaviour and estimate their lifetime value to a particular business. Other advantages of DM are that it allows stealth marketing and the opportunity to create a stable client base as a result of engendering positive perceptions of goods and services. One of the most important issues for a company using DM strategies is the eventual creation of a database of potential and existing customers. There is much more than couple of good reasons, why to use direct marketing in practise. As per researches, although direct and online marketing are booming, a large number of companies still relegate them to minor roles in their communication/promotion mix. Advertising and sales promotion departments receive most of the communication dollars and jealously guard their budgets. It is very similar in Slovakia. Advertising is still winning. Direct marketing has a strong potential of further development. But it depends only on organizations, if they will use it. It depends on their communication strategies, financial sources, and skills and will of employees and also on external factors. It is important to combine number of marketing tools to create and cultivate loyal and profitable customers. Direct marketing is one of them. Media explosion offers to enlarge number of organizations to sell products to customers directly, without intermediaries. New media refills traditional media, e.g. fax, e-mail, Internet, mobile phones. They are suitable for individual, direct and interactive communication between an organization and customers. They are suitable both to acquisition of new customers and retention of existing customers. Direct media allow specific targeting and improve offer specification.

In mass marketing the seller engages in the mass production, mass distribution, and mass promotion of one product for all buyers. But the proliferation of advertising media and distribution channels is making it difficult and increasingly expensive to reach a mass audience. How to be more productive? How to acquire, keep and enlarge number of customers? One of the possible answers is to adopt some key features of direct marketing into the practice of struggle companies. A new approach to customers is supplying a traditional marketing conception. This approach is based on individualization in relation organization – customer(s). DM has reached a new level of its development – the level of interactive marketing.

Utilization of direct marketing in Slovakia is neatly illustrated as follows:

1. DM used is used often or occasionally by one third of Slovak companies. This fact indicates positive trends of further growth.
2. The most utilized direct marketing tools are direct mail and telemarketing.
3. A lot of organizations have an interest on new information about direct marketing.
4. Direct marketing in Slovakia is evolving and enlarging.
5. Slovak advertising, DM and media market is profiling.

The Association of Direct Marketing in Slovakia (ADiMa)[i] published the economic results of its members from the years 2000, 2001 and 2002 and it recorded (compared to the previous year) nearly a 30 % increase in DM. This could be considered as a signal that DM in Slovakia is growing and it has strong potential to grow further. But it is remarkable that potential of DM in Slovakia is still not exploited. There is an assumption that DM in Slovakia, in contrary to the economically highly developed countries, is used only for 10%.

In Slovakia both individual and business customers have observed a large number of companies involved in DM. Whether organisations take advantage of the rapidly expanding e-commerce, emerging new media and the possibility of global one-to-one marketing stimulus will be influenced by the economy of the country. Occasional utilization of DM tools is replacing by continuous utilization. DM is accepted by many companies and by customers too. DM activities don't have been utilized intuitively and in short-terms. Appropriate DM activities and exploitation of particular techniques of DM should always bring profit and satisfaction to the company and must respect needs of customers. On the other hand the vast usage of DM could negatively influence consumer attitudes. DM is particularly powerful when it is applied to integrate marketing programmes that incorporate multiple sales channels and a wide range of marketing communications. If direct marketing is carefully planed and implemented, it is extremely promising marketing component. According to scholars in this field, competing firms need to find innovative ways of promoting products to their customers. This may either be achieved through innovative advertising campaigns, which capture the imagination of the customer, or through innovative means of advertising, which give the firm a differential edge over other industry players. In general, direct marketing in Slovakia appears as an extremely promising segment of marketing communications. But in contrary to this statement it is important to point out some of the latest information about attitudes of Slovaks to advertising. According to the press release of January 28, 2003 by TNS SK are Slovaks saturated by TV advertising (76%), and then by non-addressed mailing (49,9%), print advertising (44,6%). Respondents are not embarrassed by Internet advertising (11,6 %) and by transport-oriented advertising media (10,8%)[ii]. It is visible that new forms of marketing communication are replacing traditional advertising and communication media. In the case of DM there is a wide rage of new mass-communication media. Interactive marketing and m-marketing[iii] are representing current trends in direct marketing also in Slovakia. The Slovak DM market is still opened for specializing agencies although competition in this area is strong. Direct marketing could be used very effectively in Slovakia but it is difficult to predict its future use. The potential of direct marketing in Slovakia will be only fully exploited.

End Notes

[i] The Direct Marketing Association (ADiMa) was established in 1997. The key aim of ADiMa is to support the growth and using of direct marketing in practice and to support positive attitudes forward DM in public audience. The ADiMa also has constituted The Code of Ethical Principles and has started to create "the Robinson's List". Further information is available on: <http://www.adima.sk>.

[ii] Further information: <http://www.tns-global.sk>.

i) [iii] Especially: SMSmarketing and MMSmarketing.

Development of SMEs in APEC: A Comparison Between Mexico and Thailand

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Abstract

In the APEC region the SMEs are the backbone of regional economic growth. The 40 million SMEs throughout APEC economies account for over 90% of all enterprises. They also employ 32% to 84% of various economies´ work forces, contribute 30% to 60% of gross domestic product and account for 35% of exports in the region. That´s why the Small and Medium Enterprises Working Group was established as an *Ad Hoc* Policy Level Group on SMEs in February 1995. In 2000, as part of the decision of the Management Reform process, the Small and Medium-sized Enterprises Working Group (SMEWG) was granted permanent status.

After a brief presentation of the Working Group activities that facilitate an open discussion on matters affecting SMEs and enable the ministers and business people to find the common ground necessary to create a favorable policy environment for the development of SMEs, this paper presents a comparative analysis of the governmental support policies for the SMEs in two APEC members: Mexico and Thailand. We classify the policy measures provided by the governments for the promotion and support of SMEs into 3 key areas, namely (i) Investment Promotion, (ii) Financial Assistance and (iii) Technical Training and Consultancy through various administrative organizations dealing with SMEs promotion activities.

In the conclusions are compared the impacts of the policies and instruments applied in Mexico and Thailand and suggested the introduction in Mexico of some Thailand´s positive experiences. Further more, it is recommended to use the SMEWG as a permanent forum to exchange the positive experiences of the APEC members in the SMEs development instruments and policies.

Introduction

Nowadays, Thailand and Mexico are immersing in a fortifying process of their economies, due to the effects of the 90's economic crisis. Thailand recovery policy after the crisis is supported in the knowledge-based economy, which is constituted by the government, managers and international organisms such as World Bank and APEC. At the same time Mexico's government is trying to alleviate the poorest and unemployment problem with the supporting to SMEs. Mexico has to emphasize the KBE especially in Research and Development and human resources development. The purpose of this paper is to identify some government policies oriented to support the small and medium enterprises, taking the knowledge-based economy as a guide.

Importance of a Knowledge Economy

First of all, it is important to know how Knowledge Economy is defined by the World Bank: "The knowledge economy could be defined as one where 'comparative advantage [is] much less a function of natural resource endowments and capital-labour ratios and much more a function of technology and skills'. Its development is the product of two forces: a rise in the knowledge intensity of economic activities and an increasing globalization of economic affairs. It is driven by the revolution in information and communications technology, the increasing pace of technological change and by national and international deregulation.[1]

From a policy perspective the knowledge economy can be seen as consisting of four main inter-related spheres. These are: Innovation Systems: R&D, diffusion of technology, links between science and industry, firms focusing on new technology, industry clusters; Human Resource Development: basic education, scientific and engineering talent, lifelong learning, job training, organizational learning and innovation; Business Environment: regulatory environment, intellectual property rights, competition policy, tax rates, physical infrastructure;

Information and Communications Technology (ICT) Infrastructure: investment in ICT, digital networks, access to and use of ICT, growth of electronic commerce and enterprises.

The Thai knowledge system is composed of three parts: locally-owned Thai firms (especially SMEs), multinational or global corporations and other knowledge institutions such as schools/universities and government research institutes. Unfortunately the country is located in early stage in building innovation and knowledge infrastructures, related to other Asia Pacific Countries as Malaysia and Singapore.[2] “A central problem is that many government institutions and incentive schemes for industrial technology and skills upgrading are following old policy models which focus more on single entities (whether firms or institutions) than on knowledge networks, interactions and supply chains”.[3]

This country has decided to confront the international market; so the question here is what kind of policies the government of Thailand is taking into account in order to reduce the difference between old and new policies that are needed because of the globalization, and also how this decision is associated with capital talent[4] for the SMEs.

In turn Mexico tries to fortify its domestic Market through the improvement of business environment mainly with the strengthening and the establishment of SMEs, favoring in this manner the generation of jobs and the families income as a strategy of relief to the poverty, in this sense the president Fox affirmed recently that “…the poverty in Mexico has many doors of entrance, and …few doors at the outset. Because of it the generation of the self-employment, the start of micro and small business and the to undertake ‘is the door at the outset of the poverty for an extensive layer of the national population, for many families’“[5]

At the same time, Mexico seeks to favor the ICT use, the innovation systems and the human resources development as strengthening strategies of KBE in the SMEs.

Nevertheless Mexico require to emphasize the generation of high technology through R&D combined to the precision of the type of human resources that would require an economic structure based on the knowledge.

Small and Medium Enterprises

In Thailand SMEs have long been a pillar of the country's economy and they make up a large portion of national economy in terms of output, employment and effective utilization of regional resources. There are more than 850,000 SMEs and constitute over 90% of the total number of establishments. 19% are in the manufacturing sector, 26% en service, 3% in wholesaling, retailing 30% and other kind of SMEs 22%,[6] which are scattered both in Bangkok Metropolitan and regional areas. They employ about 65% of industrial workers and contribute about 47% of the total manufacturing value added.[7]

At present, there is no generally agreed definition of SMEs. Each organization has derived their own definition of SMEs for convenience in their work. The various administrative organizations which deal with the SMEs classify SMEs based on measures of fixed assets, registered capital, sales or number of employees:

a) Ministry of Industry has defined the SMEs as follows: By size of employment (small scale: less than 50 persons, medium scale: 50 - 200 persons, large scale: more than 200 persons); By fixed assets (small scale: less than Baht 20 million, medium scale: Baht 20-100 million, large scale: more than Baht 100 million)

b) The Industrial Finance Corporation of Thailand (IFCT), the Small Industry Finance Corporation (SIFC) and the Bank of Thailand define small industries as fixed asset investment less than 20 million Baht.

c) Office of the Board of Investment (BOI) has defined small scale industries with fixed assets less than Baht 10 million and medium scale industries with fixed assets more than Baht 10 million but less than Baht 100 million.

In Mexico’s case Ministry of Economy is considering into SMEs the micro their classification is by number of employees and annual sales. Micro: from 1 to 20 persons, and 900, 000 pesos; 16-100 persons, and 9 million pesos: medium scale, 101-250 persons, and 20 million pesos; and large scale more than 251 persons, and more than 20 million pesos.[8]

SMEs generate 6/10 of pesos and contribute to the economy with 42% of the national production. They are shared as follows: 13% -industry; 36%-services; and 51% commerce. Their value added which is near 50% is located in industry.[9]

SMEs in Mexico are faced with the following problems:

- Difficulty access to credit and high interest rates
- Lack of skills and management expertise
- High cost of access to information on market opportunities and technologies
- Lack of marketing skills especially for entering export markets
- Insufficient incentives
- Lack of knowledge about the procedures for entering foreign markets

Government and Some SMEs Promotion Activities[10]

Next we have some strategies and policies which the Thai and Mexican governments have implemented or are trying to develop it, in order to support the SMEs and human resources formation. It is important in other paper, to evaluate these strategies to find out their relationship with the detailed countries economic impact.

A relevant aspect is the interest of Thai government to adjust higher educational supply under minimum requirements standards according to the market activities and the emphasis of the practical experience during human resources development and the use of prices mechanism inside education and training costs, all this is supported by the long distance education.

On the other hand, E-education has been very important; was necessary to reform the basic educational level to develop curriculum and teaching procedure that support the scientific thinking, create incentive for researcher career, seed money from government budget to promote and induce R&D investment in ICT, set up R&D promotional strategy in Thai ICT, support the research work that can be applied to e-commerce industry, establish an Excellency Center. Without a doubt all these policies are supporting SMEs.

It has been considered the implementation of training programs to reduce the inequalities among small and medium-size companies. Accounts for this uneven distribution of training in Thailand is not known, but some studies reveal that while many firms do not train because the derived demand for skills from using old technology is low, many firms and SMEs, in particular, are also constrained by high labor turnover (and loss of training investments), poor knowledge about how to train or the benefits of training, and access to finance for training.

This implementation has been accompanied by a review of the legal and institutional framework, in order to make possible the SME Promotion Act thus, the Institute for SMEs Development (ISMED), and the agency called Office of Small and Medium-Sized Enterprise Promotion, the first to provide business management and technology services and training to SMEs, and the second would have the important task of disseminating information to SMEs on management, skills development and technology upgradation support services.

Also, tax incentives have been established, but there is not enough training among SMEs. Less than 2 percent of firms have been reported using the training tax exemption. The major beneficiaries of this incentive were larger firms and not SMEs, even though a high proportion of both groups of firms reported providing formal training to employees.

One of the most important strategies into SMEs is transferring and absorbing the advanced and appropriate technology, because the natures of small and medium enterprises are strongly beneficiary with this strategy. Also the use of the whole system of ICT in business management, promotes e-Business development, and use ICT for management in industrial sector, at he same time it makes the database for planning and service, and develops SMEs Portal. The purpose is to fortify the competition among this kind of enterprises.

Master Plan for development of SMEs has been established to organize this strategy in the manufacturing, trade and services sectors, which makes coherent the development of this sector, as it was said at the beginning, it represents 90% of the business in the country.

On the other hand, Mexico supports its policy for the SMEs in the Development Program for the Entrepreneur-ship (2001-2006). This program looks for the participation of local economic agents in order to elevate the enterprises competitiveness. So it is oriented to achieve a better business environment and facilitate the financial support; at the same time it is looking for ICT implementation in SMEs. As one of the most important aspects is the regional strengthening of domestic market trough creation of privet sectors value chains.[11]

SMEs policies are implemented with the following objectives: 1) To reduce the disadvantages between SMEs and large enterprises in areas such as: financing, human resource development, technology development, access to foreign markets, technology transfer and development for supporting industry, and 2) To ease the process towards increased quality and competitiveness. This is important because SMEs are facing new challenges as a result of tariff reduction and increasing competition in the domestic market. The modernization of facilities and the incorporation of more efficient technologies have become priorities for most enterprises

Especially in SMEs Human Resources Development support in Mexico the Ministry of Economy and Ministry of Work and Social Prevision promote one kind of programs oriented to competitive capacity of the enterprises. This program is focused in the creation of the National Network of Regional Centers for the Entrepreneurial Competitiveness for the advice and training trough seminars and specific courses, especially for new SMEs; Integral Quality and Modernization (CIMO); COMPITE which is oriented to the training of human resources inside the SMEs; Quality System Program in the SME. Mexican Council for Productivity and Competitiveness is responsable for enhancing productivity and competitiveness through industrial workers training program. Ministry of Finance and Public Credit grants the taxpayer a tax deduction for the contribution paid to the R&D funds.

In fact we can observe that all these programs in Mexico are focused in the capacity building of the workforce in order to increase the enterprises competitiveness, together with an enhanced business environment and incorporation of the information and communication technology.

However we can not find so clear the R&D innovation system for the SMEs. We think is necessary strengthen this factor in order to discover the high technology ways.

Some of the best programs in Mexico are the Technology Transfer Unit (UTT), the Compite Program and the CIMO Program.

The UTT is a non profit organization created by the Mexican Government trough the Ministry of Economics and the private sector through the National Chamber of Manufacturing Industry (CANACINTRA), with the participation of IBM of Mexico, S.A. UTT services are especially designed to satisfy information and technical assistance needs of SMEs, but UTT is also useful for other industries, associations and chambers, service companies, financial institutions, government and non-government institutions. It provides the enterprises with the information and technical assistance needed to solve technological and production problems, and to increase their competitiveness in the marketplace. This program includes: National and international databases, R&D institutions, libraries and information centers, consulting firms, government, international and private organizations, distance access via INTERNET.

The relevance and quality of the UTT services is ensured by an interdisciplinary group of experts. Some of the services provided are: information and advice on patents, trade marks and standards, access to specialized information through query services, technology assistance and training programs, legal advice on technology transfer contracts, development and upgrading of information systems, information and financing programs for technology development.

The objectives of the COMPITE Program are the human resource development, management support and intellectual property rights protection. Other goals of the program are to reinforce the competitiveness level of the enterprises, to increase productivity through the efficient use of production processes, to make optimal use of the enterprises resources, to establish immediate, viable and low cost solutions to the problems, to develop actions that grant added value and total consumer satisfaction.

The program provides the SMEs with a strategy to develop an efficient method of production. The operations that don{t add value to the final product, as well as the unnecessary costs are eliminated. The program consists in intensive workshops organized within the enterprises during 4 or 5 days. Authorized consultants work with an interdisciplinary group of the SME. The situation of the enterprise is analyzed based on four parameters: productivity, requested time, stocks and output. Short run problems and solutions are identified. Some measures are implemented immediately followed by a productivity increase evaluation.

The CIMO (Integral Quality and Modernization) program must foster the human resource development, the support for management and the access to information for the SMEs. The Human Resources Development Promotion Units (UPS) and the enterprises make a basic diagnosis and elaborate a strategic program for the development of SMEs. They also identify specific needs of each enterprise in order to develop common aspects and to promote the exchange of experiences. On this base the program propose specific measures, involving the different areas of enterprise. The program has financing mechanisms for human resources development, consulting services and industrial information. The Ministry of Labor and Social Welfare as well as SMEs contribute to these mecanisms with financial resources.

SME Working Group of APEC

Nowadays the interest of Thailand about Micro, Small and Medium Enterprises is related with the incorporation of Micro Enterprises Sub-Group in the APEC SMEs Working Group, starting in 2002, in Los Cabos, Mexico. In that time Mexico proposed the incorporation of the micro enterprises and micro banking sub group in APEC.

At the present time, Thailand is leader in Micro Enterprises Sub-Group which favors the link between government and APEC about the strengthening of initiatives taken for the support of SMEs in Thailand.

The principal theme of Thailand APEC 2003 “a world of differences: partnership for the future” is centered in the knowledge-based economy for all, promotion of human security, financial architecture for a world of differences, new growth enterprises, so SMEs and micro businesses , and Act on Development Pledge.

“Thailand’s fourth sub-theme is ‘new growth enterprises: SMEs and micro businesses’. Issues of concern include ‘growth? (but also ‘distribution’) and ‘entrepreneurship’ (but also ‘employment’). This seems clear enough; Thailand will maintain the emphasis on ‘shared prosperity’ established by the Shanghai Declaration of 2001, and on micro enterprise development (MED) as a means to sharing, established at Los Cabos”[12]

In 2002, in Mexico, started the discussion about the benefits of micro banking to micro enterprises for the alleviation the poorest in all APEC members. The Philippines, Taiwan, China and Indonesia are some of the economies with big experience in this field. Mexico also has some experience but unfortunately not so successful, the country is interested in exploring more about this opportunity.

In fact APEC “Accepts micro banking and/or microfinance as broadly supportive of APEC goals and objectives and to accept that significant differences exist between micro enterprises and SMEs sufficient to justify separate consideration of the needs of Micro Enterprises Development… for economic and technical cooperation.

APEC gave some recognition to micro banking for the reduction of financial exclusion in all economies and to agree on and extension of the Economic Committee’s micro banking study to consider specialized financial institutions during 2003.

Established mechanisms for further study of MED issues notably by endorsing the creation of a permanent subgroup of micro enterprises in 2003, reporting to the SME working group, and encourage cross-sectoral communication and cooperation in support of these goals”.[13]

This information allows us to know that Thailand focus on the new knowledge society and that filters this interest in dual manner. On the one side, it emphasizes the 8th and 9th Development Plans; on the other hand, it promotes the discussion in the core of the APEC. Furthermore, it favors the discussion about the SMEs unemployment This strategy impacts in the urban and rural areas.

For Mexico is relevant the incorporation of the systematic study of MED because the necessity of the country to encourage the domestic market with the APEC support. In fact in the country more than 90% of the economic activities is focused in Micro and SMEs.

So, it is possible to observe the both countries interest about favoring the SMEs as strategy of poverty alleviation and unemployment. The existence of a master plan in this issue, research innovation (especially in Thailand), the education and training such as the generation of the permanent studies of micro, small and medium enterprises are aspects that confirm this interest.

However, it is necessary to study the impacts of this interest, which has been expressed in government policies, for the generation and development of the SMEs, as detonator of employment and poverty lightening.

Conclusion

Most of the APEC economies confront development problems, just few of them are considered as developed economies. Small and Medium Enterprises are an option to the employment generation, however, they need commercialization channels of their products. People interested in new SMEs will be confronted to different problems, since their foundation, product processes and technologic improvement, until the products commercialization. The problem is bigger in sub development societies.

Competitiveness has a foundation at the micro-level, whether or not it is measured and benchmarked at the industry, sectoral or national level (Porter, Sachs and Mcarthur 2001: 21; and Meyer-Stamer 1995: 143-146). Regrettably, however, there is currently little, if any at all, data and information needed to monitor and compare the evolving capabilities and potential of the top layers of SMEs in priority sectors and industries over time. Such an exercise is indispensable for a more accurate identification of core competencies of the SMEs under consideration as well as of their shared areas of weakness for follow-up capacity building. Indeed, learning what a country and its enterprises are, or can be, good at producing is a key challenge of economic development (Rodrick 2002: 7a). But the same exercise is also essential for better SME performance management and policy impact assessment. In particular, useful benchmarks can be obtained as regards the on-going changes (whether progressive or regressive) in the capabilities and competitiveness of direct SME exporters and first-rank SME suppliers to large domestic enterprises or cross-border production networks. These benchmarks constitute a solid input for the consideration of policy framers as well as for emulation by those SMEs presently in the lower ranks or tiers of suppliers. It is very important the training and formation of people to confront the reality that implicate the SMEs establishment or strengthening. The specific abilities development and the capacity to confront the bureaucratic instances and financial take part in the human capital required to the small and medium enterprises competitively.

Thai government is looking for its knowledge-based strengthening economy trough several government initiatives. The SMEs constitution, its legislative actualization, and taxes exemption; innovation systems, training and people formation in different educational levels, but principally secondary school, represent support initiatives.

Other actions are focused on the linkage between university and industry supported by research and development, which is strengthening by Universities Autonomy process promoted by the government. However, this process is going on slowly, such as its link with the industry that directly affects the SMEs development.

Thailand ranks low in global rankings of technological and skills capability, but also the instruments used to deliver the services (e.g. taxes and subsidies) are ineffective, so the country needs to improve targeting, coordination between agencies; improve governance increase awareness and; integrate technological and skills development.

So the public policy and institutional framework for innovation must change[14]. Developing of knowledge required and the financial resources to acquire that knowledge are necessaries. So it required more State involvement for better information, human resource development and financial incentives for R&D and innovation.

The situation for Mexico is similar in the sense of the domestic market strengthening and more state involvement into the economy. The interest of the government to support SMEs is very clear in the last times because they generate a very important share of the national production in the export-import and taxes framework.

Unfortunately the support to Micro and SMEs in Human Resources Development is not enough especially in innovation systems and Research and Development for micro, small and medium enterprises. It seems is necessary for the country to find more connection points between the factors of the knowledge - based economy.

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Consumer Change in Japan: A Longitudinal Study

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Abstract

The research question pursued in this paper is how the process of market developments will impact on foreign affiliated companies in Japan. It is based on a study and observations of the pre and post-bubble changes in the Japanese market at key epochs: 1990, 1992, 1995, 1998, 2000 and 2003. Using an approach influenced by Grounded Theory, the research involved 75 personal interviews and meetings with executives of 67 successful foreign firms operating in Japan, as well as several other agencies in 2003. A framework distilled from an earlier article on the subject (Reid 1995) is used to compare and contrast the situations at key stages over the last decade.

A Moribund Japan

Many foreign observers seem to have lost interest in Japan largely because of its inability to inspire growth. Its poor economic performance since the bubble burst in 1992 and the efforts of several prime ministers to revive it have apparently met with little impact. Nevertheless, the world cannot afford to write it off. Japan still has the second-biggest economy, and with current worries over sluggish growth in the United States and recession in Germany, it becomes more urgent than ever that Japan exerts its potential in motivating the world economy. Moreover, The Economist (2003) points out that Japan's experience now looks disturbingly relevant to Europe and America, given the risk that deflation may spread.

Where once, its economic performance invited well-deserved admiration; now, Japan attracts ridicule as it has repeatedly failed to escape from economic slump and eliminate so-called non performing loans (NPLs) as well as falling short in its ability to reform its shaky politics and corrupt bureaucracy. Yet, to outsiders, the depth of the problem is not so immediately apparent. The continuation of the recession, Takahashi (1997) avers, along with a volatile yen and changes in world markets, are bringing about less visible changes, as in the structure of management and employers' diminishing obligations to employees. Lay-offs are ongoing, the result of which is unemployment reaching an all time high by the beginning of 2003 (Sanchanta 2003). While In the centers of major cities many people still appear affluent, townships of homeless people have begun to appear. And the screw continues to tighten: wage and salaries declined by over 5 percent during 1998-2003 as the number of employees declined by 2 million (Interview data). The Economist 2003a reveals that some are trying to draw links between these economic hardships and Japan's rising crime rates. (The most recent white paper showed that violent offences, including robbery and rape, more than doubled between 1997 and 2001.) If any link exists between crime and unemployment, the crucial aim will be to increase the number of jobs available to the young, who make up a disproportionate share of both criminals and the unemployed.

During the thirteen years over which this research has been conducted, the Japanese economy has, for a long interlude, been the envy of the world, and its financial markets the source of spectacular wealth. Other countries have scrambled for Japanese investment. And, much of it poured into North America to buy bonds, property and companies; also to build factories for Japanese manufacturers that were reinventing entire industries. Foreigners wanting to see how things were done homed in on Japan, where the firms were studied as models of efficiency and innovation, and their ideas of employee involvement, quality control and design were copied around the world (The Economist 1998b). Yet, the situation had changed so dramatically and Japan endured a resilient recession that on April 3 1998, Moody's, the leading international credit rating agency, challenged whether Japan deserved its top credit rating (The Economist 1998a). By October the new government decided to boost spending by issuing ¥30,000 shopping vouchers, valid for a limited time period, to each member of its population of 125 million. The government also introduced special holidays, Happy Mondays, to encourage people to go to the stores to spend the vouchers (Financial Times 1998). In the same month, the Japanese government's proposal to use 67 trillion yen of public money to purchase the banks' NPLs and reorganize the banking system was met with hope from around the world. This hope rapidly turned to despair in the face of subsequent inaction.

Critical commentary usually takes place at the macro level and is, almost by definition, highly abstract. What is missed, in the abstract, is that elimination of non performing loans may lubricate the banking system but at the cost of smaller companies that are depending on credit lines. This is a salient issue because, as Thornton (1998) explains, almost half of Japan's industrial output stems from small and mid-size manufacturers—some 800,000 small operations where much of the work is often done by hand in small workshops that line suburban back streets. In Thornton's Business Week article it is stressed that into the millennium many of these small suppliers were expected to be battling for survival: struggling for bank credit, trying to cope with stagnant domestic demand, and crumbling under pressure from big corporate customers to cut their prices.

The contrast with the glory days of the 1980s is indeed stark. Senior Japanese executive now joke self-deprecatingly with this author about their moribund economy. And nowadays few foreigners travel to Japan in search of answers. More likely they come from western capitals and other capitals to prod the Japanese government into reviving its failing economy. Foreigners cannot understand why paralysis is so widespread, and so entrenched.

Some, however, including Morgan Stanley's London-based currency team, believe there are three reasons to think that Japan has turned the corner. Its central bank is finally taking a more expansionary stance under Toshihiko Fukui, its new governor; while domestic investors are rediscovering an appetite for risk amid economic recovery; and, according to the Financial Times, Junichiro Koizumi, the 'reformist' prime minister, is reinforcing his political position (Financial Times 2003). Indeed, he succeeded in fighting off a leadership challenge in September 2003. None of these arguments, however, are persuasive. It is true that Mr. Fukui is less hawkish than his predecessor, but remains wary of truly radical action. Though, Japanese investors have started buying Japanese equities, this speculative interest could evaporate. Moreover, reformist Koizumi remains in power precisely because he has abandoned most of his initial structural reform promises.

The Bank of Japan's Tankan survey of business confidence is a respected metric. As reported in The Economist (Respite without reform 2003), the companies polled in the latest Tankan survey are still suffering. Among large manufacturers, the pessimists outnumbered the optimists by 38 percentage points in the quarter just ended (Figure 1). But, for the first time since September 2000, that metric has stopped worsening.

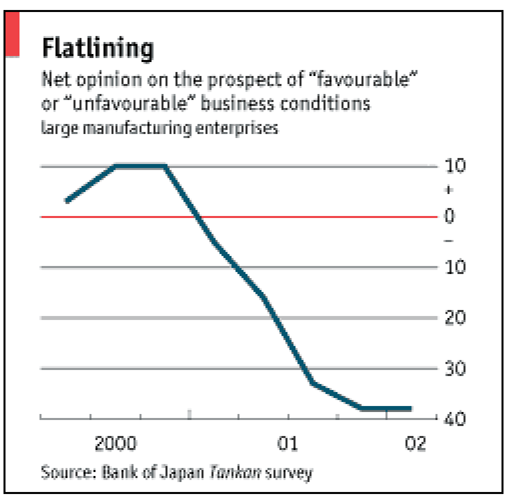

FIGURE 1: TANKAN SURVEY

Senior executives interviewed in 1995, in the course of this research, revealed that Japanese banks were adopting an aggressive approach and offering multi-million dollar loans on the strength of their published balance sheets. By 1998, however, it was a different story. The Economist (1998c) informs that strapped for capital, and carrying bad debts equivalent to, perhaps, 30 per cent of the country's Gross Domestic Product (GDP), Japan's beleaguered banks were reluctant to lend to any company with the slightest hint of risk. Unfortunately, the effects of this are felt mainly by smallish domestically oriented concerns. With exports slowing and domestic spending stagnant at best, this became a matter of disquiet. However, Japanese banks continued to have access to cheap funds but unfortunately, they continued to lend inappropriately. So, even though the equivalent of 20 percent of Japanese GDP in non-performing-loans (NPLs) were written off by early 2003, by mid year we learn that ten percent of Japanese GDP still remains in NPLs (Interview materials 2003). Japanese policy makers are at pains to point out that writing off these NPLs means prejudicing businesses and jobs. This would further exacerbate the general state of unhappiness: in the twelve months preceding June 2003, Japan, for the first time, witnessed more suicides than road traffic deaths.

Japanese Competitive Environment

While the Japanese market is traditionally considered to be obstructive and difficult to penetrate, experts on Japan have shown this view to be misleading. For example, Goodnow and Kosenko (1993) identified six strategies that have been particularly successful for North American companies. According to Yoshihara (1991), thriving foreign affiliated companies (FACs) exhibit several success factors: a management philosophy that holds true at the international level; high technological capabilities; and acceptance of the Japanese subsidiary as a strategic base. Other studies have pointed to US-based and European multinational corporations (MNEs) that possess these qualities (Gleckman 1996; Guild, Shill, and Yamaguchi 1996; Sweetman 1996).

Allen (1994) maintains that if a company can understand the Japanese market and play by the rules, then it will succeed in Japan. Reid (1995) presents evidence to show not only that foreign companies can succeed, but that they have developed leadership positions in the Japanese consumer products market. Hirsh (1991), on the other hand, claims that it is only companies competing in the non-strategic [for Japan] sectors that have been allowed to succeed.

A select number of foreign players have become established leaders in the Japanese market. Coca-Cola, for example, generates 30 per cent of its profits from Japan. IBM employs 20,000 people in what is the world's second largest information technology (IT) market. Ubiquitous MNEs such as Procter and Gamble and Unilever each command around 13 per cent of the highly competitive hair care market (Interview materials), and this achieved at the expense of formidable Japanese competitors such as Kao and Kanebo.

Prior to the bursting of the Japanese bubble, the prerequisites for success in the Japanese market were beginning to become clear. FACs thought they could interpret the big spending consumers. But, all that changed. As Johansson and Hirano (1996) illustrated, in post-bubble Japan the business environment changed and the rules for doing business altered radically. Notwithstanding, Johansson and Hirano (1996) contend that corrections of this ilk have a positive side, and argue that the changing situation in the Japanese market has opened up new opportunities for Western companies. In response this paper sets out to further examine the ongoing changes in the business environment arising from over a decade of economic stagnation, and identify the nature of new opportunities for FACs.

Method

The fieldwork carried out in Japan involved 75 personal interviews with executives of 52 successful FACs as well as a series of other informed individuals. These firms, primarily consumer-products oriented, and mainly recognized household brand names, are listed in Table 1. The research, focused on a representative sample of FACs, each of which had successfully developed a position in the Japanese consumer products market.

An approach influenced by Grounded Theory (GT) was adopted. GT is inductively derived from the study it represents; that is it is discovered, developed and provisionally verified through systematic data collection and analysis pertaining to the phenomenon. Thus, data collection, analysis and theory stand in reciprocal relationship with each other. One does not begin with a theory, then prove it; rather one begins with an area of study and allows what is relevant to that area to emerge (Strauss and Corbin 1990:24). As yet, the GT approach is underutilized though becoming increasingly popular in the management literature. For example, a search during September 2003 of ABI databases over the last decade unearthed 115 articles, whereas an earlier search conducted in 1999 unearthed only 34.

The initial sample for the present study was generated by using snowball sampling. This involves gathering a sample through chain referral (Burt and Ronchi 1994; Waldorf and Biernacki 1981). Using first the principle of open sampling to uncover as many potentially relevant categories as possible (Strauss and Corbin 1990: 181), the process of selection began with a list of foreign consumer goods companies that had successfully established a presence in Japan. The list was developed with the help of major consulting firms like McKinsey and the Boston Consulting Group; also major advertising agencies with offices in Tokyo, such as BBDO and McCann Erickson, were asked to name the most successful foreign players. At the outset major multinational enterprises with long-established positions in Japan, for example Unilever and Johnson & Johnson (J&J) were invited and their acceptance was leveraged to encourage others to participate. The companies identified (N=66) were then contacted by telephone, invited to participate in the study and, as mentioned above, the executives of 52 companies agreed. These were supplemented by meetings with 17 more in 2003.

Consideration was given to the assessment of the experience of companies that had failed or made dramatic mistakes. For obvious reasons, outright failures cease to exist and are difficult to track, although a record was made of some names of executives who had left Japan and might have had experience to share. However, none of the companies interviewed represented pure successes; most of them had experienced their share of errors over the years, and some of their learning is reflected here.

The individual interviews, on average lasting around two hours, were conducted across a range of executive groups: CEOs (45), vice-presidents (15) and other senior representatives (15). At the end of each interview, respondents were asked to suggest other FACs that, to their knowledge, were achieving success in Japan. As the interviewing program proceeded, it became clear from the extent of duplication of the suggestions received, which of the FACs were viewed as the major success stories.

The data was collected in three phases: initially, during the latter part of 1990, with follow-up by telephone and fax continuing through 1991-1992; then, to examine post-bubble issues, a second phase of 24 interviews was conducted in 1995. These second-phase interviewees were selected according to the principles of theoretical sampling, "sampling on the basis of concepts that have relevance to the evolving theory" (Strauss and Corbin 1990:176). To keep the research up-to-date, a telephone follow-up was made in 1996. During this second (1995–1996) phase, some of the original companies (1990 fieldwork) were re-interviewed, and some technologically intensive companies such as Compaq and Microsoft were added. In some instances, the same individuals were still occupying the same positions, whereas in others, their replacements were interviewed.

A follow up visit was made in 2000 and in 2003 an additional phase was added. The emerging constructs were found to be stable from throughout this time period. These were supplemented by sessions with a variety of other informed sources, accessed recently by way of the author participating in a study tour in 2003 hosted by AACSB and the respected think tank Keizai-Koho Center, to learn directly of the 'Japanese economy: its challenge for revival'. The itinerary took us to Tokyo, Naro, Hamamatsu, Nagoya and Kyoto. We received inputs from the Bank of Japan, Nomura, the Commissioner for Cultural Affairs, Politicians, Hakuhodo Institute of Life and Living (a consumer research house) and others. We also made visits to Ito Yokado (retail conglomerate) owner of the highly successful Seven-Eleven chain of convenience stores, Hamamatsu Photonics (high-tech venture business), Toyota Motor Corporation and Sharp Corporation to study its direction in LCD development. We also visited the Hitotsubashi University Graduate School of Commerce and Management. The program started and ended in Tokyo. It culminated with a symposium, attended by high-level members of the business community, at which an exchange of views was made on Japan's future economic development.

The fieldwork followed a list of topics and themes designed to explore the macroeconomic and business-environmental issues, market and competitive trends and their strategic responses to these stimuli, but were not confined to them so that "grounded theory wisdom" (Bailey 1987; Glaser and Strauss 1967) could surface. That is to say that the study was not limited by a priori hypotheses; rather the data were allowed to emerge according to the perceived importance by the interviewees.

The list of topics was committed to memory and each individual was asked the same questions in an identical fashion. However, the sequence was allowed to vary in order to facilitate what was constructed to be a conversational interaction. The interviewees were probed on the difficulties involved in marketing in Japan, thus enabling identification of specific differences in contrast to other markets. While respondents were allowed to range broadly, coverage of key topics was ensured. All interviews and meetings were recorded; in some cases company documents were provided for subsequent analysis. Some interviewees were agreeable to being quoted, others not. Those who refused to be quoted were given neutral attributions in the analysis of data.

The contents of the interviews were reviewed several times and were transcribed. In this way, not only was the author's memory refreshed but also an in-depth contextual understanding of the issues was achieved. The data was then analyzed qualitatively with NVivo (Richards 1999), a software product designed for this purpose. After reviewing the data, a framework was generated that was cross-referenced to the context of the interview

1990-1996-2003 Pre and Post Bubble: An Evolving Shift

Key themes that emerged from the data on the Japanese business environment, specifically on the collapse of prices and distribution, are now presented. These are supplemented by a framework, distilled from two earlier articles in the Journal of International Marketing (Reid 1995; Reid 1999), which is used to compare and contrast the pre- and post-bubble situations and the process of ongoing change. A number of quotations from senior executives, based on the 1995–1996 and 2003 fieldwork are offered in support. The framework, with an italicized summary of the key elements from the Reid (1995) article, is based on the following topics:

?? The Japanese business environment
?? Radical consumers
?? Heritage
?? Hedonism
?? Consumer interest criteria
?? Product churning behavior
?? Radical opportunities
?? Ferocious competitive standards
?? Need to sharpen marketing skills.

Given that the GT approach yields different amounts of insight, depending upon what emerges; the sections on the pre- and post-bubble situations are of varying length. Specifically, changes in the Japanese business environment are dealt with in more detail because of their underlying significance for changes in other areas. An analysis of consumer interest criteria is seen as generic to a discussion of market changes, and this topic is also tackled in greater depth than the other topics in the framework.

The Japanese Business Environment

Foreign companies in Japan have learned that the primary obstacles to success are not invisible trade barriers but rather the high costs of operating in Japan and the extreme competitiveness of the market (Reid 1995). Essentially the Post-Bubble environment is riddled with pessimism. Senior Japanese executives now make self-deprecatory remarks about the state of their country and their inability as Japanese to wrest themselves from their moribund state. Japanese seemed fatalistic and often not exhibiting the spirit that made Japan great and to become an example which many of us wished to study. Hence they are being exhorted, by billboard advertising, to be proud to be Japanese and feel pride to be part of a culture that, in 2002, delivered two Nobel prizewinners from different fields, together with a coterie of other world-class Japanese luminaries.

Government lacks, according to our 2003 briefings, the courage to initiate change. Japan's aging demographics demand that the social security system be overhauled. Yet, to court popularity, Prime Minister Koizumi has pledged not to change the consumption tax rate which limits fiscal flexibility significantly and the ability to engineer radical change. He is, we are told, not brave enough to be the radical reformer he claims to be: merely enjoying his interval of fame. But, little evidence emerged that the political machine has moved into gear to deal with the crisis in a manner appropriate to its magnitude and valence, or in the experience of this author even to give frank answers to sensitive questions.

This is unfortunate as the malaise infects the mood of the people and influences purchasing behavior. For example, the collapse of the property and stock markets has resulted in a sharp reduction of paper wealth. Corporate entertaining budgets have been cut, as a consequence Japanese men compensated for the loss of their drinking money by commanding larger allowances from the housekeeping budgets, which reinforces an endemic trend toward parsimony in buying behavior.

In the 1995-96 interviews, CEOs of FACs cited the new price consciousness among consumers, and the consequent price destruction in all business sectors, as the most significant changes arising from the bursting of the bubble. These changes have emerged as a result of both company and consumer responses to the new climate. Personal Care companies such as Bristol Myers, L'Oreal, Nippon Lever and Procter and Gamble typify the foreign companies that have experienced a collapse of prices their products command at retail levels. The impact of price-cutting on L'Oreal, for example, is typical of that experienced by companies that had developed a market position predicated on premium pricing. Supermarkets contained a series of products among which there would be sub-groups of more expensive products. Foreign manufacturers used to be able to achieve impact with their shelving positions while establishing price points higher than local suppliers maintained.

Senior executives of L'Oreal saw significant declines in the prices of L'Oreal products in a number of sectors during 1994–1996. For L'Oreal the post-bubble market delivered a shift to lower prices, larger packaging formats and smaller margins, coupled with a pressure to increase media advertising. The bursting of the price bubble saw accelerated retailer discounting leaving those companies with high-margin brands, such as L'Oreal, especially vulnerable as their brands became discounted increasingly. It is in this context of price collapse that L'Oreal, and others like it, must learn to survive in the market. From a consumer's perspective, the coupling of falling prices with the fear of lay-offs is causing them to postpone purchasing endlessly. The ramifications of this deflationary behavior are far-reaching, with some radical changes occurring in the wholesaler and retail sectors.

Environmental pressure groups abound. They make their views known and educate passing pedestrians about the issues of the day. In some important ways Japan is exercising a leadership role, for example, the introduction of anti-smoking initiatives in outdoor areas of the Tokyo Central Business District. Nowhere else in the world has this been attempted, it is akin to setting up a chain of girlie bars in Mecca. The streets and sidewalks are cleaner than ever and largely free of cigarette butts. It is impressive and appropriate that Japan should set this example. In Japan, where smoking is so endemic this action has import beyond the environment. This is as a very positive indication that Japan may be capable of grappling with and bringing about necessary change.

However, the economy and banking system is hobbled by non performing loans (NPLs). They are concentrated in certain sectors: construction, automobiles, for example. Banks can afford to maintain NPLs because interest costs are zero and continuing payments by borrowers constitute incremental income. Indeed, Japanese banks attracted the ire of many of the experts interviewed. Seemingly, many loans, made by banks, were advanced without sound business predicates. And Japanese banks have been pursuing their business by staking their loan capital in unsound investments against land as collateral. They often did not extend due diligence as the conventional wisdom held that land values on these over populated islands would always increase. Many of these NPLs are therefore pledged against declining land assets. Traditionally, vast amounts amount of land would be held by the wealthy as assets, but in response to the turn-down in values these assets are now pouring onto the market. Because of decreasing land values, the pattern, now endemic deters borrowing and fuels deflation. There are large amounts of un-rented office space in Tokyo which further exacerbates and reinforces the deflationary trend.

It was possible to glean that a major restructuring of the 'Japanese model' is underway. For instance, the attraction of foreign direct investment (FDI) is on the national agenda. Areas such as Hamamatsu, with long-standing reputations as innovative regions, having given birth to the likes of Honda and Yamaha, are actively promoting their areas. Another initiative involves the National University where, currently, members of faculty are classified as government servants, so there is no incentive to make extra contributions beyond the minimum and much sloth prevails. As from next year, however, universities in the national system will be given freer rein and faculty will no longer be government officers. Institutions will be subject to both inspections and evaluation of teaching and research in a manner similar to the British model.

Distribution:

Unlike the system in the West, where manufacturers tend to supply large retailers direct, deliveries in Japan are made to retailers via wholesalers. Aggressive wholesalers continue to acquire less resilient concerns to expand their coverage while, at the same time, increasing their concentration. Among the interviewees, some major consumer products manufacturers, working with distribution systems containing over 1,000 wholesalers, are attempting to reduce the numbers of tiers in their channels, as well as the absolute number of wholesalers through which they work. At the retail level changes are ongoing.

Daiei, until 1998 was Japan’s largest supermarket group has been replaced in the top slots of Income and after tax profits by Ito Yokado. Daiei is now accused by its competitors, Ito Yokado primarily, an interviewee, of losing focus by attempting to continue to apply a 1950s American model of supermarketing. Japan has strained the ability of many of the world’s major retail operations. Carrefour, for instance, the French owned hypermarket operation is struggling to replicate its China-like success in Japan. The British retailer, Marks and Spencer (M&S), has shown interest from time to time but according to Ito Yokado it discouraged M&S from pursuing this interest. Boots Ltd, the British pharmacy and personal care chain attempted to develop a position and even opened a store in Ginza. That venture was quietly disbanded. Wal-Mart has acquired over 60 percent of Seiyu and is using this as a bridgehead into the market. So far, according to interviewees, none of the major Japanese retail players are perturbed about this.

Discounting:

Discount operations that sell both private brands and parallel imports were, by the year 2000, interviewees from McKinsey estimate, to increase their share of the household products markets by 37 per cent to 60 per cent. Mom and Pop stores, once considered an extension of the social security system, are being replaced by convenience stores. Chains of outlets such as Lawson and Seven-Eleven proliferate, and gaining distribution in these outlets is essential for the success of consumer products.

A result of this movement has been to wrest many categories from department stores, in some cases entirely. It is hard to find any example of cameras and photographic equipment in department stores: this category is now dominated by discount chains. Men’s suits are another category which has found discounted distribution. Tokyo Suits, for example, offers a wide variety of style and size, sourced mainly from Italy at price points around the ¥20,000 mark. Indeed, mastery of a China-based supply chain is showing to be one of the planks in the strategy of Japanese companies, and this is highly apparent in the apparel business. Providers of men’s’ suits have learned to work with Chinese apparel producers to ensure that they can produce at the high levels of quality to satisfy Japanese purchasers.

Return on Investment:

Many retailers, interviewees maintain, are now focused on Return on Investment rather than being preoccupied, as in recent but earlier times, with market share by volume. So, they no longer disregard the cost of maintaining high inventories comprised of a multiplicity of brands: retailers now appraise commercial opportunities through a different lens, one that focuses on return per square foot. Inventory turnover is now a major issue, whereas once it was not. POS terminals and Electronic Data Interchange (EDI) are being speedily introduced. Many Japanese retailers these days are aware of what has been sold in the last hour or two. Major retailers are linking into manufacturers’ computer systems and are able to trigger automatic stock replenishment. One of the companies studied in 2003, Ito Yokado, the retailing group that owns, among others Seven-Eleven, is regarded as the most advanced in Japan with respect to the application of EDI to retailing. Ito Yokado claims that its subsidiary Seven-Eleven is ahead of the holding company in terms of EDI and is second only to Wal-Mart, which in turn was inspired by Ito Yokado.

Cheaper and Faster:

Given the consumers' new value-driven propensity, there is a reduction in shopping purely as a mode of entertainment, many consumers forego service providing they save money; hence the growth of large low-service outlets such as Toys 'R'Us. Japanese consumers, like consumers elsewhere, want things faster. This has implications for many companies and their brand strategies. For example, Levi-Strauss Japan used to typically offer its product in one leg length and expect the consumer to wait 30 minutes or so while the alteration was made in the shop. Levi's President now recognizes that its customers have more immediate expectations in that they expect to choose the right leg length and be able to complete the purchase in less than five minutes: So to speed up the difference between thirty minutes and five minutes…to some people probably still isn't much. But to you and me and to a lot of our consumers it's twenty-five minutes too long. Then look at what that does to retail space; they [retailers] are not set up for carrying two or three leg lengths because they are carrying too many brands. So, the decision that many retailers are wrestling with now is 'Do I keep several brands of jeans or do I figure which ones are providing the best return in terms of sales per square foot, dump the rest and maximize the sales of those few.

Vertical Restructuring:

Since retailers are attempting to improve ROI as well as stock-turn, yet maintain an increasing number of sizes and variations, this is inevitably leading to the exclusion of less popular brands and an increasing focus on so called 'power brands'. This, in turn, may provide additional thrust for the vertical integration of retail chains: both foreign and local. This we are seeing with respect to the coming together of Wal-Mart and Seiyu. Other Japanese retailing chains are beginning to forge closer ties.

International Sourcing:

Downward spiraling prices are impacting severely in the arena of distribution. In particular, it has encouraged international sourcing. What happens when all retailers can buy at the lowest available landed price? International sourcing by supermarket chains posed a competitive threat to those Japanese manufacturers dependent upon high-cost structures. Conversely, it presents opportunities for those that have international linkages. And these companies have worked with Chinese suppliers to overcome Japanese reservations on quality to such an extent that 34 percent of product in major Japanese supermarkets is now sourced from China. Indigenous suppliers, focused on the Japanese market, have been more threatened by these developments than FACs, which, by definition, have international connections.

Radical Consumers

Japanese consumers sample and adopt new, and sometimes eccentric, products more readily than Western counterparts (Reid 1995). Japanese society imposes very specific role definitions on male and females. Traditionally the male household head would leave for work early in the morning, commute to work, then spend time after work drinking and eating with his colleagues. However, interviewees assert that this has started to change. Corporate entertaining has been cut back drastically causing many men to return home to their families early in the evenings. Since 1990 one of the most acute changes in lifestyle is that families are spending more time together. However, this does not imply increase of closeness. They rarely find the time to sit down as a family and even when they do, they generalize from their eating out experience and seek individualized meal experiences: mother may eat something left over from a previous meal, the son pizza, father sushi, etc. Each family member may have his or her own favorite shampoo, and other toiletry products, and everyone has his or her own favorite items in their kitchen and in their refrigerator'. So a father might like this brand of beer; son might like something else; the wife may prefer a different brand still. We witness ad hoc cooking, ad hoc and individual shopping, individual cooking, even individual menus when they sit together.

This shift does not nurture radical consumption behavior. Indeed, the reverse is true (See Hedonism below). What has happened is that there has been some re-balancing between work and leisure. There is evidence of a new sense of chore sharing between males and females and a pronounced move from groupism to individuality. The higher incidence of females remaining in the workforce after marriage has liberated males as consumers. With working wives they can and do consume more and differently.

Heritage

Because of cramped living conditions in Japanese cities coupled with a heritage of concern for aesthetics, the Japanese consumer is a key target for luxury designer items (Reid 1995).
Japan has for a long time been a key market for foreign luxury brand producers. Interviewees maintain that is because Japanese use them as compensation for living in cramped and otherwise parsimonious conditions.

Given the consumers' newfound concern for value for money, one would expect that the post-bubble climate might mediate against designer products. However, this is not solely the case. Major labels such as Chanel continue to maintain strong distribution presences. In parallel with the proliferation of designer labels is the 100 yen ($1) store phenomenon. The Ferragamo consumer is, some of the time, the same consumer who shops in the 100 yen store. All night auctions are also very popular: equivalent to a car boot sale, consumers transport items they earlier paid a fortune for and auction them for cash so they can buy more fashionable items. To some extent, however, after a decade of economic melancholy, Japanese consumers' love affair with European luxury goods appears to be losing some of its spark. To rekindle enthusiasm, Sager (2003) maintains luxury retailers such as Ferragamo, Louis Vuitton, Coach and Prada are all opening big stores. Prada invested $85 million in its so-called mega store in Tokyo and which opened on June 7, 2003.

Unfortunately, these new shopping magnets are opening just as Japan's luxury goods market appears to be ebbing ? with sales expected to drop 4% during 2003. Apparently retailers calculate the new stores will help them get a bigger slice of a shrinking pie. It worked for Louis Vuitton: its sales jumped 15% during 2002, to $1.16 billion despite the economic downturn. Other international luxury brands are investing in further growth: Christian Dior, Lanvin and Mont Blanc have recently opened boutiques in Ginza. Seemingly the office ladies who once made shopping trips to Hong Kong are now forgoing these breaks and staying at home but buying their designer bags in Japan (The Economist 1999). Some designer labels have even begun to appear in discount outlets. It seems that during the high-yen era some of the discount chains, taking advantage of employees' tax free allowances, have sent their employees on buying sprees to European fashion houses such as Chanel, Louis Vuitton, and the like, in order to retail the designer wares through their outlets.

An interesting trend that combines parsimony with heritage is a trend exhibited by young females to return to wearing the kimono. These can be bought at huge discounts (up to 90 percent) of the new price. This has spurred several major businesses dealing in antique kimonos as well as the creation of service businesses that train wearers in the ritual obligations of kimono wearing.

Hedonism

Japanese consumers exhibit a great propensity for foreign travel and out-of-home experiences such as eating and drinking (Reid 1995). The average Japanese housewife, as Tajima (1989) put it, has had two wallets to pick from, her own and her husband's. She controls them both. On receiving her husband's net salary, she allocates "pocket money" to meet an agreed set of expenditures. So-called salarymen husbands previously were able to supplement their allowances by claiming for drinks, dinners, even taxis home, as a consequence of the "onerous" entertainment practices in which they engaged. According to research conducted by Coca-Cola Japan Co. Ltd., the increased tendency of males to dine at home has imposed an additional burden on the housekeeping budget. At the same time, husbands' need for more "pocket money" to offset the loss of expense account living, has, in turn, further increased housekeeping expenses. As the Vice President Coca Cola Japan put it: Cutbacks in corporate entertainment are driving different behavior inside the home. There was a trend to more eating out and more fast food restaurants but that is changing again. Now more people are eating at home.

Clearly hedonism is being diminished somewhat. Japanese consumers are more inward looking towards their homes. This is the trend that is driving the popularity of DIY stores such as Tokyo Hands, which now abound in Tokyo. Another key change is an awakening of interest in healthy life styles. Organic foods are increasingly popular.

Adult education, always popular, is now becoming more license-oriented. Hitherto Japanese management has been populated by generalists. This model appeared to work well enough insofar as outsiders could tell. On the other hand there was little opportunity to obtain an MBA in Japan. Those making an investment in MBA education abroad were unable to secure worthwhile premiums in the kaisha and many bled away into Foreign Affiliated Companies. Today there is an increasing uptake of adult education. Although adult education has typically been geared to pursuing and developing new interests, the focus is now more license-oriented. Furthermore more Japan-based MBA programs exist. The International University of Japan and Hitotsubashi University, for example, offer programs, some taught in English, including executive programs taught, in the evenings, in the Central Business districts. Hitotsubashi Graduate School of Corporate Strategy now occupies 4-9F of the National Center of Sciences Gakujutsu Sogo Center. Hitotsubashi has also recently made significant investment in world-class teaching facilities on its campus and is attempting to recruit foreign visiting scholars.

Consumer Interest Criteria

A preoccupation with travel and an obsession with quality translate into preference for foreign designer brands and opportunities for premium pricing (Reid 1995). Japanese consumers have, since the economy initially flourished been considered rich in comparison to their Western counterparts. However, these purported rich consumers, if living in the cities, normally experience very restricted living space and, interviewees maintain, enjoy a doubtful quality of life. There was general agreement among those senior executives interviewed that, to offset these disadvantages, Japanese consumers maintain an obsessive interest in newness by indulging themselves with the consumption of new products, especially designer brands.

The consumers' new concern is for value. They now regard quality as an unspoken entitlement and are unequivocal about the need for product performance that satisfies their new price/value equation. This has resulted in closer examination of functional claims and less reliance on buying brands merely for the sake of the brand name. The increasing popularity of private brands is partial testament to this. Many retailers are working closely with both foreign and local manufacturers to develop private brands that can be sold at lower prices but which retain consumer standing. As the CEO of Levi Strauss explained: People are looking at things in terms of utility and value more often. 'What do I need this for, what will it do for me, is it easy to look after, and is it flexible? They are looking less slavishly at designer brand names…The price/value equation is much more realistically applied.

Similarly, another interviewee, James Abegglen, Chairman of Gemini Consulting and author of Kaisha: The Japanese Corporation, had this to say: It has changed from where Japanese will pay any price for quality. Now price/value is the most important thing.

Senior executives interviewed for this study disclosed that not only have many people forgone salary increases, usually awarded twice each year, but their bonuses, an important remuneration component, have been cut back. Research houses that track consumer concerns, ASI Market Research (Japan) for example, observe that consumers' concern for quality has remained static whereas the ranking of value for money has increased. Another research house interviewed, Infoplan, performs an annual survey of social values, attitude shifts and consequent behavioral change. According to Infoplan's CEO: Japanese consumers increasingly want to make smart decisions and aren't going to pay premiums merely because they want the badge of success. But they don't necessarily want cheap, cheap. On the contrary by 2003, Hakuhodo informs, the concern with freshness and purity has become so robust that farmers are able to charge significant premiums for organically grown rice on the platform that it is safe and tastes better. This organic movement now transcends into the ready to eat meals market. Sandwiches, are labeled as containing organic lettuce and such.

Product Churning

Japanese companies churn out new products irrespective, seemingly, of market and financial rationale (Reid 1995). Interviewees in 1990 maintained that Japanese companies, obsessed by market share, tended to be highly committed to winning business wars. A common practice, detailed elsewhere by Jones and Ohbora (1990) was 'product churning', seemingly irrespective of the relationship between costs and gains.

It was also generally accepted among the 1990 interviewees that Japan's fast pace of change was a significant factor in the business environment. Many people argue that, in Japan, everything happens faster than in any other country. A one-day market leader can rapidly—within months—almost cease to exist. It is a market where successes soon become history. For example, in the late 1980s and early 1990s, Nippon Lever shocked its Japanese competitors, Kao in particular, by seizing over 10 per cent of the shampoo market with its Timotei brand. Yet, within four years that brand had all but disappeared from the shelves.

There is a tendency routinely to follow competition and emulate what competitors do, irrespective of economic rationale. The Managing Director of Nippon Lever highlighted this trait: In this market you can be sure if you have got a bright idea, it is copied within a year, and within two years everybody has done it and, therefore, you very quickly lose your novelty. Unless you keep improving it, you could find quickly that you are at the end of the road. So I would say those are the two main lessons out of the Timotei experience.

There is a slight reduction in product churning activity in the post-bubble era. Although, the interviewees maintain that, with a zero growth rate, the environment has become much less predictable. Consequently, the style of competition has changed. According to several of the executives interviewed, so-called one time growth industries are operating like mature industries. The Managing Director of Infoplan gave the following illustration: It may show maturity in a particular industry in that brands are becoming more important and there is more concentration on line extensions and product reformulation. I hypothesize that for economic considerations there are fewer new products launched. I also hypothesize there's less in reality because the market is more mature.

Radical Opportunities

Major foreign players have uncharacteristic Japanese product portfolios. Opportunities for radically different products abound (Reid 1995). Coca-Cola's product mix in Japan is quite unlike anything that exists elsewhere in the Coca-Cola international network. Its major seller in Japan is not cola; it is mainly focused on coffees and teas. These products are often dispensed in cans via vending machines, hot in winter and cold in summer. These vending machines proliferate even in relatively quiet suburban streets. Although not the first into the market, Coca Cola Japan was able to use its distribution clout to dominate the market for canned coffee. It has made a successful strategy out of being second. But in the post-bubble era, in an arena that still sees over one thousand new product introductions in any single year, it has, of necessity, become committed to a more aggressive stance in staking out its leadership position.

Functionality now plays a big part in the post-bubble consumers' evaluative process. According to Coca-Cola, its consumers are becoming smarter and are challenging imagery-based claims. Yet this drive for functionality can register in many ways. By way of illustration, Coca-Cola consumers that initially switched to cheaper imported colas eventually began to examine their construct of value and reverted to the major brand. Apparently, in this sector consumers weigh quality, dependability and reliability as well as price, and are inclined to balance these elements.

Ferocious Competitive Standards

A presence in Japan is necessary to maintain competitive advantage world-wide (Reid 1995). One of the keys to success for FACs has long been thought to become a Japanese insider. Several foreign companies, for example Kodak, when interviewed in 1990, claimed 'to become part of the Japanese scientific and technological community' was its primary objective for being in Japan. When re-interviewed in 1995, Kodak had 'let a number of people go', including newly hired graduates, and, as a result, had suffered a major credibility setback. Clearly, the implications of balancing return to shareholders with the costs of maintaining a competitive edge in Japan are difficult to weigh.

Japan, with its fast pace of business, should be a good training ground for company executives. Abegglen, the Chairman of Gemini described the changing trends: As a generalization through 1960-70, people sent to Japan were of no great distinction, for the most part. I don't think Japan was seen as a training ground in any sense. In the late 1970's as Japan moved up very sharply and rather suddenly on the agenda of international companies, there was quite an effort made to move potential top management into Japan as part of the training exercise.

The notion of establishing a Japan presence fails to win general appreciation because of the high operating costs. Several interviewees believe that the costs of doing business in post-bubble Japan are so great and the competitive environment so tough that they overpower the benefits that may be derived from using Japan as a training ground. Some made the point that the United States is also a highly competitive market and a much cheaper location for international executive postings. There is evidence that FACs in Japan are tending to hire younger single-status executives as a means of containing mushrooming costs. So, instead of adding to the expertise of senior executives the level of expertise among the gaijin contingent declined throughout the 1990s and into the new millenium.

Need to Sharpen Marketing Skills

The pace of movement in Japan provokes a sharpening of marketing skills (Reid 1995). Successful players in the Japanese market typically require the benefits of scale to contain costs. The absence of critical mass leaves companies vulnerable to their Japanese competitors, which are highly developed predators. For example, according to the President of Bristol Myers: In the consumer products' arena, a sales-force of less than 100 will suit only a niche player. Once they sense weakness, Japanese competitors prey mercilessly on the vulnerable party by investing in new products, boosting advertising and other combative marketing initiatives.

Many interviewees claimed that the major players in key business sectors are becoming stronger, generating greater cash flows while strengthening their research and development and product development efforts. Simultaneously, weaker players are being squeezed. Some key Japanese sectors are becoming more concentrated. For example, the top three Japanese manufacturers in the Personal Care sector, Shiseido, Kao and Kanebo now have a combined market share of 40 per cent of their domestic market, much more, according to Nippon Lever, than the top three international players would command on the world stage.

With respect to sharpening marketing skills, there are lessons to be learned from Japanese marketers, an issue brought into sharp relief by the President of Bristol Myers: My marketers here attend focus groups every night of the week. Every night of the week sitting watching the groups, that's how they get close to the consumer. When I was in the UK I would do it once or twice but usually I would await the report. To do that here you would be despised. Table 2 (below) provides a summary of the significant factors operating in the fiercely competitive business environment of post-bubble Japan.

TABLE 2 SUMMARY OF FACTORS, CHANGES AND IMPLICATIONS

Framework factor	**Post-Bubble Change**	**Implications**
Japanese business environment	Price destruction, distribution becoming more concentrated. Increasing expectations of fast retailer response. Seeming political complacency but evidence of change underway.	Power brands, vertical integration to encompass retail sector. Enhanced 'value added' will be a criterion for success.
Radical consumers	More balance between work and family. Some convergence to 'international values'. Individualized mass consumption.	More and different products consumed in the home. Single person packaging sizes of consumer products. Greater variety of product and brand choosing in family unit.
Heritage	Luxury designer products hold strong but consumers more price/value conscious. Luxury products sold through discount outlets. Rise in popularity of night auctions and 100 yen stores Some resurgence of traditionalism	Quality and image remain important but supplemented by functional and value claims. Expensive and inexpensive purchases made by same consumers. New array of service-based opportunities
Hedonism	Less hedonism, more interest in healthy living. Organic foods, adult education	More license orientation with respect to adult education
Consumer interest criteria	More value-for-money driven behavior. Parallel importing a major issue.	Justify positioning of brands and price levels. Value driven positionings. Mastery of a China-based supply chain a major competitive advantage
Product churning	Reduction in product emulation activity	Products must have genuine consumer justification.
Radical opportunities	Increased emphasis on functional performance. Less slavish brand devotion.	Stress on dependability and function.
Ferocious competitive standards	Japan remains a tough highly competitive environment. FACs attempting 'insider strategies' are struggling.	Adopt those aspects of 'insiderism' that are financially justified.
Need to sharpen marketing skills	Marketers in Japan maintain dedicated dialogue with consumer. New environment requires high interpretative efforts.	Gear up effort to track and interpret contemporary needs of consumer.

Conclusions

Having reviewed the temporal market changes, induced as a result of the collapse of the bubble, it is clear that several fundamental changes in the business environment have occurred. Prices are deflating in all sectors. Consumers are, as a result, delaying purchasing. They have become more balanced in their orientation and weigh value more heavily than previously. Consumers shop around more rationally, even in 100 yen stores, and consequently, are less likely to pay premium prices. Competition, responsive as ever, remains fierce. Despite the downturn, media expenditures remain high, imposing high cost burdens on all players. FACs that are attempting to develop market positions are specially challenged as they are squeezed by high costs and increasing price conscious consumer behavior (see Table 2 above).

The new climate has spurred changes in the distribution system. Less competitive wholesalers are being swallowed by more aggressive concerns. The demise of Mom and Pop Stores has been hastened by the ascendancy of price-competitive convenience chains. Retailers are more focused on profitability and are adopting newer technologies that will help depress retail prices further.

Some reduction in product chuming among Japanese companies has occurred. It is recognized that products in the post-bubble era must have a real consumer-based justification to survive. Evidence of this is the premium that put on speed of service. Also, keener pricing is stimulating international sourcing, which advantages those companies with international linkages, FACs in particular. This trend to international sourcing and parallel importing includes designer labels, which are now also discounted.

The tendency of consumers to buy cheaper products is a challenge for FACs. Wherever possible, they must find opportunities to re-engineer creatively the positioning of their brands in ways that justify price premiums. Brand propositions are required that are capable of working responsively in environments where discounting intrudes, fashions swing and consumer mores shift radically. There is a need for big brand ideas that capitalize on the consumers' drive for greater value but also meet the Japanese consumers' requirement for quality.

Japanese competitors were once regarded as unsophisticated marketers. What they lacked in terms of marketing sophistry, if ever true, is now compensated for by their dedication to gaining an in-depth understanding of their consumers. Japan's post-bubble experience is likely to result in a number of pervasive changes. Many elements of its previous success paradigm will be reappraised, if not discarded. New-found wisdom from the price destruction experience will permeate many aspects of business and trading behavior. Japanese companies will negotiate more stringent terms with international suppliers, making Japan an even tougher market in which to compete.

On the output side, Japanese products are likely to become even more competitive, as Japanese companies become leaner and meaner. This is especially true in the likely scenario of a weakening yen. For FACs, such an environment poses a formidable challenge, but one that will be ultimately to their benefit should they succeed in applying the resultant expertise to their operations elsewhere.

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Contact the author for a list of references.

Suitable Market Entry Modes for International Franchisors in China

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Abstract

This paper focuses on international franchising in china, mainly analyses the international franchising market entry modes and the impact of China's WTO accession on franchising. The research results show that as for the popularity of the entry modes, master franchising is the method used by 57 percent of responding members internationally, licensing is used by 19 percent of respondents to the new survey, joint venture by 12 percent and foreign subsidiary by 6 percent. Also, because of the huge difference between Chinese culture and Western culture, direct franchising is not the most suitable mode for an international franchisor to enter China. Indirect international franchising and joint venture appear to be more suitable for China.

Introduction

As the business environments in China are becoming more and more sound and China itself is becoming increasingly involved in international business, especially after joining the WTO, more and more foreign franchisors are eyeing this potential markets and try to tap this most promising market. Although there are some famous international franchisors operating in China now, such as Macdonald's, it still adopts the foreign direct investment entry modes and, equity joint venture. The famous franchisor applied this joint venture method due to the legal limitations that they are not permitted by the Chinese government to build wholly owned subsidiaries. Now the Chinese government release their regulations about foreign investment in China, international franchisors can pursue their most favorite modes comparatively free (Chou, 2002). Under this situation, the problems facing the international franchisors are what are the suitable entry modes and what factors should be taken into account when they want to do franchising in the Chinese market.

The research on 'how best to franchise in China?' is rare. That's why I choose this topic. I will analyze the entry modes of international franchising and find out the most suitable entry modes of international franchising in my research project. It is my greatest pleasure if my research can give some guidance for the foreign franchisors to choose the proper entry mode of franchising into the Chinese market.

Three Stages of Franchising in China

The embryo stage (1986-1992):

Franchising began to be adopted as a brand-new mode of operation with the entrance of McDonald and KFC in China in mid and late 1980's. In the light of the laws and regulation in that period, franchising was conducted in the form of joint venture rather than sale of chartered right, and franchising business characterized by the sale of chartered right didn't exist in a true sense in China. In the mean time, some Chinese restaurants with traditional prestige were expanding their business by means of alliance and transferring brand and technology. These firms, bearing some traits of franchising in their operations, became the first generation of Chinese franchising.

The growth stage (1993-1996):

In this stage, some world-famous franchisors entered Chinese market in great numbers. Brands of clothing, restaurants became well-known, such as Pierre Carden, Crocodile, Geodano, Apples, KFC, McDonald, Fiji, Kodak and so on.

With the initial experiences acquired and foreign modes for reference, Chinese enterprises started to take actions to develop its own franchising in a planned way. Relaxation of some restrictions made it possible for foreign franchisors to expand quickly in China. In this stage, Chinese franchising was focusing on three areas: restaurants, retailing business and clothing Business.

For shortage of regulations and laws in franchising, and for lack of knowledge of the importance of brands and standard operation and management, this stage remained probing stage for franchising in China.

The popularization and standardization stage (1997—present).

In this period, the departments concerned published a series of policies related to chain-store operations and more Chinese firms began to expand franchising business under the standard of "3 Unifications"—— unified procurement, unified delivery and unified management. In this period, Chinese franchising has been fundamentally framed.

The Current Situation of Franchising in China

Rapid Development

According to the statistical report from Chinese Chain-Store Association, by the end of June 2002, Chinese franchisors are up to 1000, more than half of them began their franchising operation after 2000. Out of the top 100 chain stores, are 61 franchising enterprises with the sales volume up to RMB 27 billion, accounting for 17 percent of the total sales of the top 100 chain stores. The number of franchised shops has increase to 5400, constituting 40 percent of the top 100 chain stores. Franchised shops developed more rapidly than chain stores both in terms of sales volume and the number of increased shops. For example, from October of 1995 to end July 2003, Shanghai Hualian supermarket cultivated 2006 franchisees; Malan Noodle, 436 from October 1997 to 2002. Since the beginning of 2003, Chinese franchising has swiftly developed in many other industries and franchising systems has increased nearly to 2000.

A broad range of trades with franchising

Franchising has been broadly applied to over 50 industries, between which franchising in service industry is the most vigorous and developing rapidly. Apart from traditional restaurants, retailing, and individual service, franchising in some new and developing industries, such as cultural and educational industry, commercial service, household service, auto-related service, IT industry are rapidly advancing. The latest news reports that government-authorized franchising system will be set up in municipal public sectors, that is to say, monopoly will be broken away in some traditional municipal public sectors which is directly related to social public benefits, such as city water supply, air feed, wastewater treatment, trash treatment and public transportation and implement franchising under government authorization.

Diversified and multileveled franchising

In the course of developing franchising, enterprises, based on their understanding of franchising and objective conditions, brought out varied forms of development. Firstly, some enterprises, depending on their business brands and managerial dominance, enlist potential franchisees by means of advertisements and exhibition. Secondly, some enterprises, through internal ownership transfer, transfer the ownership of chain stores to employees and meanwhile sign up join-up contracts. Thirdly, as for those chain stores, in which some part of ownership is non-transferable, or their employees are unable or unwilling to take over the ownership, employees are permitted to pay a percentage mortgage for the transfer of operation right and then sign up join-up contracts, and finally become a franchised store of the enterprise. Fourthly, some poor-operating-and-stand-at-the-bay enterprises will be brought into franchising system.

Laws to abide by in franchising

Franchising is not one or two behaviors of some enterprises alone. As a brand-new form of business, franchising plays a significant role in pushing forward the development of the service, stabilizing medium-sized and small enterprises, increasing employment opportunities, and satisfying consumer demands.

Government impetus and its supporting policies on franchising

Government supporting policies guarantee the sound development of franchising in China. In 2001, Vice Premier Li Lanqing inspected many chain-store enterprises and made comments and instructions on chain-store operation. The State Economy and Trade Committee, the former Ministry of Internal Trade and the State Commission for Structural Reforms have ever co-held a symposium on chain-store operation application. The former Ministry of Internal Trade placed chain-store operation as a primary task. China Industrial and Commercial Bank provided RMB 37.5 billion of preferential loan for franchising. All levels of local governments, various organizations concerned framed a series of policies and launched activities for the purpose of promoting franchising.

Literature on Methods of International Franchising Expansion

Freeman (1999) points out that franchising can be viewed as a licensing relationship within which an owner (the franchisor) of a trademark (including service trademark), product, patent, know-how or business method grants exclusive rights to affiliated dealers (the franchisees), and in return receives a payment or royalty and conformance to quality standards.

Franchising entry modes have provided many good opportunities for multinational firms to expand to overseas markets with comparatively less resources and risks, so the international franchising entry modes have long intrigued many researchers (Chan and Justis, 1990; Niu, 2001;Justis & Judd, 1998; Martin 1992). There are a number of different approaches to international expansion that are commonly in use. These include:

1 Company-owned only operations or indirect franchising
2 Direct franchising
3 The establishment of a subsidiary
4 The establishment of an area developer
5 The grant of master franchise rights
6 The entry into of a joint venture
7 Wholly-owned foreign enterprise

Let us examine each in turn.

Company-owned only operations or indirect franchising

In such a case the master franchisor would decide not to franchise in the target territory but only to establish its own operations. In order to do this the company would have to possess the manpower and financial resources to establish and sustain the operation. A successful company-owned network would, of course, provide the basis for the future use of the franchise marketing method for growth if a change of course were considered desirable. Usually the master franchisor will also have sufficient knowledge of local conditions of franchising concepts. Normally the master franchiser starts one or two stores to engage sub-franchisees or to open all stores themselves.

The major advantages of this system are:

1 It leverages the master franchiser's resources and knowing of local market conditions to get off the ground quickly.
2 The master franchisers can adopt and, if necessary, adapt policies to fit the market place successfully.
3 The master franchiser is able to establish a showcase (a successful franchise operation) to generate and promote sales of sub-franchises.

The major disadvantages of the system are:

1 The involvement of the master franchiser can reduce the profits of both the franchisor and the sub-franchisees.
2 The franchisor loses the direct control to the local market.
3 An unqualified master franchiser could impede the franchiser’s expansion plans and, in the worst case, damage the brand.

Direct franchising

This involves the franchisor in entering into a franchise agreement with each individual franchisee and providing the basic support directly. As a technique it is normally limited in scope since the further away the franchisor is from the target territory the more difficult it becomes to serve franchisees. Very often direct franchising, combined with the establishment of branches or subsidiaries, can provide tax advantages (Kahler and Kramer, 1997).

The use of the direct franchising method also makes the franchisor vulnerable to a failure to recognize the differences, which exist between the territory of origin of the system and the target territory. However, direct international franchising has some disadvantages that are either unique to China or, at the very least, magnified in China:

1 Cultural difference between the franchisor and the host country could cause problems in the absence of an

intermediary.

2 If the franchisor were not fully aware of the ground realities of the host country, it would not be able to modify or formulate policies to ensure that its franchisees succeed. For instance, when KFC opened in China, it realized that its "finger licking good" campaign was a flop in China, because the Chinese hated eating with our hands. Eventually, KFC began to give disposable, plastic gloves to its patrons in China so we could eat without having to lick their fingers. Though several years pasted, the practice of providing gloves has long been discontinued.

3 The average Chinese does not share the Westem view on dignity of labor. To the average, educated Chinese, to do menial work--even if well paying--is a "loss of face" (dignity). Thus, an average, educated Chinese would rather be doing a low paying, white-collar job than work as an owner-operator of a franchise because it involves menial work.

The establishment of a branch operation

This may be set up in the following circumstances:

1 The franchisor may be operating its own outlets.

2 The franchiser is franchising direct into the target territory and has established a branch operation to service franchisees.

3 The branch has been established as a regional base to provide services to franchisees within the region. Fiscal may well affect whether or not a branch is established or legal considerations rather than the business need to have a presence in the territory. These considerations may lead the franchisor to follow the next course available to it, the establishment of a subsidiary.

The establishment of a subsidiary

The establishment of a subsidiary may fulfill any of four functions:

1 The franchisor could be franchising directly from its territory into the target territory and will use the subsidiary to service franchisees.

2 The franchisee may grant master franchise rights to the subsidiary and the subsidiary will be either opening its own operations or sub-franchising or both.

3 The subsidiary may be involved with a joint venture partner.

4 The subsidiary may be used as a regional base either to provide services to franchisees in the region or to master franchisees in the region. The service which the branch or subsidiary would provide would be similar in nature and would cover the whole range of franchisor services, including, as the network develops, a training facility (Martin, 1992).

The grant of master franchise rights

This form of arrangement has many of the characteristics of the area development agreement. The area developer will undoubtedly have the right to a part of a country. The master franchisee will usually have the exclusive right within a country either to open its own outlets or to sub-franchise or to do both. The master franchisee in essence stands in the shoes of the franchisor in the country and is, to all intents and purposes, the franchisor of the system in that country (Pawan & Dant, 1994).

The franchisor has to consider a number of points:

1 The difficulties in identifying and selecting the right master franchisee.

2 The need to have a strong home base to sustain the demands.

3 The diversion of manpower and financial resources from the domestic operations. It should be noted that it will always take more people and cost more money than one would expect.

4 The time factor - it will always take much longer than one expects.

The problems, which arise when the franchisor feels it has no alternative but to terminate, are many and varied. It is likely that the franchisor will inherit problems since termination will result either from the master franchisee having done its job badly or because it is not doing very well.

The entry into of a joint venture

This involves the franchisor in establishing a joint company with another company or person within the territory, and the exploitation of the territory either by means of operations owned by the joint venture, as by sub-franchising, or a combination of both.

EJVs are limited liability corporations in which Chinese and foreign partners jointly invest cash and management resources through a directorate. Profits and losses are shared in proportion to the investment contributed by each partner. Noticeably, foreign investment cannot be less than 25 percent of the registered capital in this method. This is a popular form of cooperation, because it is ideal for companies that possess technology and access to a market but either do not have ample capitals or wish to mitigate their risks (Konigsberg, 1990).

Wholly owned foreign enterprise (WOFE)

WOFE is also limited liability enterprises, but the registered capital is entirely provided by the foreign investor. With the improvement of investment climate and increasing of investor's confidence, WOFE is becoming an increasingly popular vehicle for entry into China. This is probably the best mode for a franchisor that has knowledge of the local market and sufficient capital to manage operations until they become self-sustaining. The foreign investor has full control in WOFE, at the same time, it also requires that the foreign investor must have a good management team in place to ensure good harmony with the workers and good relationship with the various authorities such as Revenue, Industry and Commerce Bureau etc, with whom the WOFE would have to interact from time to time (Kahler and Kramer, 1997).

The Impacts of China's Entrance into WTO on Franchising

Many TNCs believe that any global enterprise that desires to survive in the 21st Century must enter the market of China. Based on this perspective, many TNCs alter "a strategic option" of the entrance into China into " a strategic necessity", so China will be the biggest, and the most potential-abundant franchising market. Since China's entrance into WTO, the circulation of goods and the field of service commerce have further broadened; its capacious markets have become the hot spot of foreign investment. Nowadays, Chinese franchising is confronted with double challenges. On one hand, Chinese franchising enterprises are not fully reinforced yet, and they have much room for perfection. On the other hand, in competition with foreign franchising tycoons, Chinese enterprises must adjust their operations in order to conform to the international franchising practices, laws and regulation as soon as possible. Meanwhile, Chinese enterprises should frame a new culture-empowered business mode, solve the bottleneck problem, which threatens the enterprise's survival and restricts its development, and thereafter inaugurate a new era of capital expansion.

WTO Agreements' influence on Chinese Franchising

In the process of negotiating on China's entrance into WTO, service industry is the hard core. Distribution service is the focus of negotiation. In addition to retailing and wholesales, distribution also includes direct selling, agency, franchising, inventory, delivery and after-sale service, etc. In respect of franchising, China promised that foreign enterprises is eligible for developing direct-selling in China in the form of franchising and all restrictions concerned will be removed in 3 years. China also allowed foreign-fund enterprises to sell their products manufactured in China and provide relevant services, including after-sale service. With China's entrance into WTO, some foreign franchising brands are taking quick actions to enter the market of China in the fields of fast food, education, retailing, commercial service, etc. The data from Chain-Store Operation Association show that franchisors from Hong Kong outshine others in clothing franchising, and franchisors from Taiwan do a better job in restaurants. European and American countries show prominence in retailing.

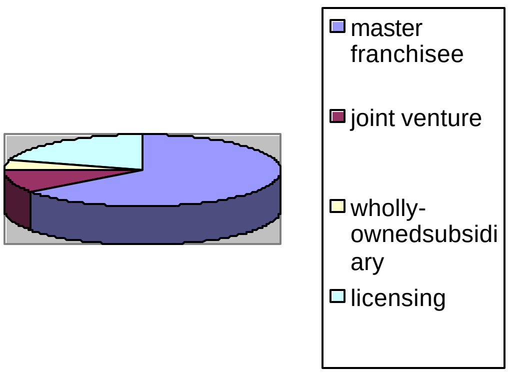
The impact of China's entrance into WTO may be analyzed from both sides. Firstly, after the entrance, Chinese franchising enterprises can acquire other countries' ripe experience, advanced technologies and managerial skills so that they can improve their operation in a short time. Secondly, the entrance of some large-scale chain-store groups will enable the Chinese enterprises to learn from them at home, reduce the grafting cost and learning cost and become more competitive. Thirdly, through franchising the medium and small-scale distribution systems will be better organized, so they will become more competitive. In a society, more franchising enterprises mean more replications of original technique, original services, original operations and successful economies. Franchising can improve the quality of products and services, raise the over-all level of products and services and thereafter promote the whole society's economic profits and commercial civilization.

However, more foreign enterprises with their well-known brands entering China to strengthen the penetration of their brands with advanced franchising technology will surely bring about huge pressure to the

Chinese franchising. In the coming several years, survival of the fittest in the reintegration of franchising enterprises in various trades will be an inevitable fact.

Results

\As for the popularity of these entry modes, Justis & Judd (1998) describe that master franchising is the method used by 57 percent of responding members internationally, licensing are used by 19 percent of respondents to the new survey, joint venture by 12 percent and foreign subsidiary by 6 percent. Of those respondents, 66 percent have an international division in their corporate structure to oversee foreign franchise development.



Source: Justis & Judd (1998), *Franchising, Chapter 22*, second edition, Prentice Hall

Because the huge difference between Chinese culture and Western culture, the difficulties of direct franchising far outweigh the advantages of it. In my view, direct franchising is not the most suitable mode for international franchisor to enter China. It is more suitable for countries that are culturally homogenous. It is not quite suitable when the franchisor seek to enter a country that is culturally different from the franchisor's home country.

Indirect international franchising may be more suitable for China, because the presence of a master franchisee that knows the territory and has the resources to develop the market is an essential bridge between the franchisor and the franchisee. In fact, a knowledgeable and resourceful master franchisee can make international brand localization better. The time for undertaking master franchisee is mature now.

Joint venture is also another more suitable entry mode for international franchisors to enter the Chinese market as China has a unique culture and the cultural difference will pose investment risk. In addition, with the help of local partners, a franchisor will enter Chinese market successfully and expand quickly with relatively less resources and risks. This form may be suitable for a franchisor with limited resources that is seeking to expand quickly with the help of a powerful local partner. However, a chicken-and-egg situation exists here. A relatively unknown franchisor is unlikely to command attention from a powerful local partner, while a well-known franchisor may not be willing to give up or share access to the Chinese market, which comprises of 22% of the world population.

Under the licensing form of cooperation, an international franchisor will license a franchise right to a Chinese vendor. This type of undertaking has limited relevance to franchising in fact. Currently, coca-cola has entered Chinese market by licensing bottlers (technically, franchising bottlers) and providing the syrup necessary to produce the soft drink.

Cooperative joint venture cannot be taken as a vehicle for franchising entry mode in China unless the franchisor is well experienced in China and the domestic partner is well known and trustworthy.

With the investment climate having improved and the investor confidence increasing, wholly owned subsidiary is becoming an increasingly popular mode for entry into China. This is perhaps the best mode for an international franchisor that has knowledge of the local market and the cash flow to manage operations until they become self-sustaining. The foreign franchisor has full control therefore he must have a good relationship with the local government such as Custom, tax, and so on. In the future, perhaps this is more appropriate for international franchisor to enter the potential market with a more deregulation of China's foreign currency control and more perfect legal climate.

Conclusion

On both theories and practice basis, my paper discussed a few ways of international franchising firms entering the Chinese market. Decision concerning the modes of international firms' entry to the Chinese markets is the most crucially important. All the factors, such as cost, possible loss of control, the risk involved etc, must be taken into account before making the decision of the entry modes. Finally, due to the complexity of the international franchising market entry modes, the one choice may be linked to another. For this reason, international franchisors may adopt a combination of entry modes when operating in China.

As China continues to experiment with a market economy and new method of doing business, franchising will become one of the most attractive methods of doing business there. It shows that franchising will be the fastest growing way of doing business in China. However, given the rapidly changing legal system, ever evolving laws and regulations and the different culture, a franchisor should carefully decide his entry strategy when entering China. Done correctly, franchising offers an opportunity for entry China's vast market with minimal capital investment and excellent profits.

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New Trends in Marketing Management and Management of Customer Relations

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Abstract

Today's marketing represents a business philosophy primarily oriented on the customer, satisfaction of his/her needs and wishes. Marketing has become a company function that identifies unsaturated needs and wishes, defines and measures their size, determines which target markets can be served best by the company, decides about particular goods, services, and programmes which are intended to serve the markets and address everyone in the company to "think of the customer and serve him/her". From the societal viewpoint marketing is the force that utilises the industrial capacity of the society in satisfying the society's material needs.

Introduction

The characteristics of the new market environment can be summarised as follows:

Ever growing power of the customer status and purchase power concentration can be characterised primarily by rational behaviour of the customer in his/her choice and preference of a brand, decreasing impact of advertising in terms of the decline of its efficiency and last, but not least, by mergers as an outcome of hard competition in which just the best wins. Most companies try to over satisfy the customers' expectations and thus enhance their loyalty. Many of them have started applying "life-long need satisfaction" marketing which means that they provide so-called life-long supply of regularly consumed goods (such as coffee, tea and the like), of course, for the lower unit price (HASPROVA 2002:43).

Scattered consumer markets allow for the so-called "micromarketing", the concept of which is focused on the strategy for ever-decreasing consumer markets with the aim to get as close to the customer as possible and produce in accord with his/her needs and wishes. The success here is conditioned by the existence of high-level flexibility in case of preference changes and the immediate producer's response. In this concept, for instance, the advertisements in mass media have not proved to be efficient communication tools with the "small markets". On the contrary, most decisions originate during the purchase itself. And thus, utilising database marketing with precisely specified target groups has proved very useful. Geodemographic databases include sets of demographic data (gender, age, address), socio-economic data (job, income) as well as data on purchasing behaviour, life style and the like. To acquire such a database has become a priority for many businesses while they represent an important competition tool that can be applied in serving new markets.

Necessity to identify competitive advantage resources is derived from the ever-growing saturation of the market. To be successful in competition, the company must enhance its relationships with individual parts of a distribution chain. Primarily, it has to establish or strengthen its relationship with customers via maximisation of the value it offers. Not only it covers the price to be paid for the product, but also the product reliability, safety, simplicity of operation or its familiarity. The relationship with dealers can also represent a competitive advantage when providing the total product value to the customer including the price. Finally, appropriate selection of a supplier and efficiency of the entire supply chain exercise their importance for the success of the company in serving a particular market. Integration of a supplier-customer chain has become an important factor for the success in a competitive environment. While total costs and service quality are dependent on the structure of the supplier-customer chain to a degree as well as on the communication within it, it is crucial to pay appropriate attention to its management.

At present, when serving the consumer markets most businesses frequently face the following problems:
The consumer is more and more experienced and sensitive to the price. The consumer exercises more and more complex life style and requires more comfort when buying. The consumer enlarges the requirements related to

services and becomes less and less loyal to the supplier. Businesses spend inefficiently a lot of means on communication with the market (advertising becomes more expensive and more inefficient at the same time, costs of sale support and salespersons management grow). The offered products are just slightly distinct from the products of competitors.

Thus, marketing managers have to answer the following questions:

1. How to define the right segment/segments on which to focus all business activities?
2. How to differentiate the offer from the offer of competition?
3. How to react to the sustainable customers' pressure on price cuts?
4. How far one can go in adjusting products to the individual customer's needs?
5. How to cut costs in order to gain customers?
6. How to build customers/consumers' loyalty?
7. How to identify the most efficient customer segments?
8. How to stand up to competition with never ending competitor's price cuts?
9. How to measure advertising, sale support and PR efficiency?
10. How to increase salespersons' productivity?
11. How to build more sale channels and secure their efficiency?
12. How to direct the other company units so that they would focus on customer needs?

The consumer/customer's position and his/her role in the modern concept of marketing management is indisputable, however, it is obvious, that in this coordinated effort of marketing management the marketing department is not the only unit whose locus of interest lies in the customer/consumer as it is presented in the following description of the ideal roster of the other units' activities oriented on the customer.

In the current marketing theory, customer relationship management has become one of the most preferred fields of experts' interest. The customer playing the "key" role in marketers' focus is more and more highlighted in the view of building long-term and prospective relationships projected to the future.

In addition to the others, the important source of information for gaining the first contacts with the customer is the Internet as an electronic medium. The Internet represents an extraordinary source of information of various types, forms, contents, relevance, reliability, price, and quality. As a public medium it enables the access of millions of users to the documents of diverse characters (ZAK 2002:74).

When considering the customer relations marketing, the main concept is value creation. The development of the relationship requires thorough knowledge of the process in which the customer creates the value. If the entire process is taken into consideration, the importance of a single purchase decreases. Thus, the management of relationship with the customer is not aimed at the increase of single purchase revenue, but at the establishment of a sustainable relationship with the customer.

The concept of customer relationship management is deeply embedded in understanding of the customer's value creation process, i.e. the process in which the customer creates for his/her own value for him/herself. The business oriented on the customer relations tries to learn more about the ways in which the customers create their own values. Then, assessing how the business can help the customer becomes much easier.

Without the principal understanding of value creation, it is difficult to develop the relationship with the customer either from the customer's perspective or the business's one.

P. Drucker claims that it is the role of marketing "to create customers". In the endeavour to satisfy the customer needs, in the process of exchange the seller tries to provide the maximum added value to the customer. The consumer added value is set as a difference between the total consumer value and the total consumer price. The total consumer value is given as a set of benefits the customer expects to gain from the product. The total consumer price is given as a set of "prices" that must be paid by the customer trying to get the product (financial costs, psychical effort and the like) (KOTLER 2000:50).

Focus on the relationship with the customer requires the shift to the search for and pursuit of general gain. The aim is no more to be close to the customer, but to "live" with one.

Traditionally, the relationships with the customer represent a triangle, the peaks of which can be named a customer, company and product (Fig. 1). As a rule, one of the peaks is emphasised. For instance, abilities and knowledge of the company oriented on the product culminate directly in the product itself and thus, the company model is developed around the product. Such a company is often identified as a company oriented on the product.

The company oriented on the customer looks at its activities from the viewpoint of the customer him/herself. In such a company, every customer has his/her own contact person who looks after the mutual relationship between the customer and the company. The company oriented on the product stresses the development of production processes and enhancement of their efficiency.

In relationship with the customer, the company utilises its own abilities and knowledge to support the value creation by the customer. Thus, the identification of such abilities and knowledge necessary to secure a competitive advantage is more important here than the product itself. The company must consider how to transfer its own abilities and knowledge to the customer so that the value can be created. In traditional marketing thinking, companies distribute values in the form of products. In the management of relationship with the customer, the company and the customer create the value together. Focus on the relationship with the customer thus elevates value distribution to value creation.

Value creation requires wide range emotion and information exchanges as well as negotiations that contribute to the value creation. Any exchange enhancing value creation process of the customer should be taken for part of the offer.

Such thinking emphasises the need to look at the knowledge and abilities in a different way – a new one. In business, product sales do not stand for the entire activity. On the contrary, it primarily stands for the exploitation of abilities and knowledge with regard to the support of the relationship with the customer for the time of its duration.

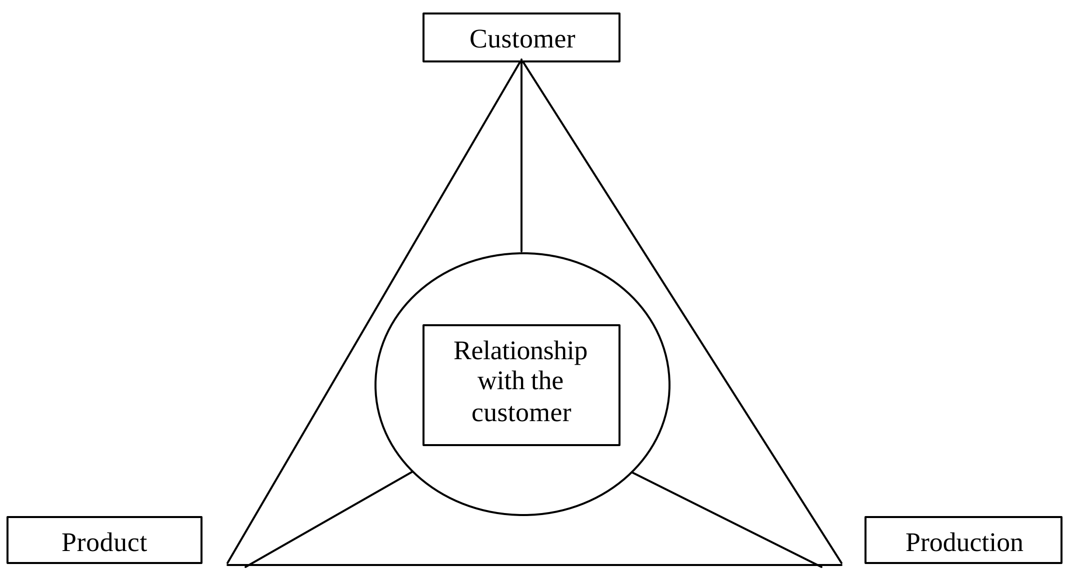

FIGURE 1 CUSTOMER RELATIONSHIP (STORBACKA – LEHTINEN 2002: 20)

The concept of customer relationship management can be described as a dual approach: on the one hand, it is the shift from the traditional business thinking towards the customer relations management, on the other hand, it is the shift in thinking with the product in its locus towards ability-oriented thinking.

Summary

A lot of top managers report that marketing is becoming less efficient. Increasing marketing costs generate lower economic results. Change in market environment brings a new approach to management of marketing activities in companies. Current marketing defines itself as an art of reaching and maintaining profitable customers. Under increased market saturation the focus is on customer loyalty and customer relationship marketing which has become part of management. A company incorporates customer relationship marketing into the strategy of increasing customers' value creation.

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How and What Has Been Done on Country-of-Origin: A Classification and Foreground Studies

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Abstract

Country-of-origin represents one of the most studied topics in international marketing. Many researchers have worked on it trying to understand the effects on consumer behavior. Globalization has not make easy this task and generalizations are more needed than ever. Therefore, it is critically important for businesses to understand the consumer attitudes and the effect they may have on product success or failure. This paper presents an extensive literature review of country-of-origin and its classification of foreground studies. The major groups considered in that classification are research in marketing, construct decomposition, cross-cultural/national generalizability, and research in related areas. This classification integrates and contrasts most of the studies employing the country-of-origin construct.

Introduction

Since the mid-1960s, numerous studies have been conducted on Country-of-Origin. The focus of those studies was on the 'Made-in' images of products. In general, they have found that consumers have significantly different general perceptions of products made in different countries. Since those days, that stream of research has produced a substantial amount of publications and presentations in congresses. Probably, country-of-origin has been one of the most prolific and researched area in marketing.

It is convenient for any firm deciding to access a new market to evaluate possible country-of-origin effects. Next, it is worthwhile to consider whether a global or local approach will be follow. Whether the firm decides to originate the product locally or overseas, the decision may imply important market and marketing consequences. Among others are the awareness of products of foreign origin, the market size, language used on the label, customers culture, status of other brands found in the market, and the brand positioning of its country-of-origin [Klein, 2002]. The country-of-origin effects seem to have a direct impact on the consumer's overall perceived quality of the products [Bilkey & Nes, 1982; Peterson & Jolibert, 1995; Verlegh & Steenkamp, 1999]. In consequence, the selected approach seems to be paramount for the firm's success particularly considering the customers' perception regarding the country-of-origin of the products. Steadily, consumers can choose for a great variety of similar domestic and foreign products. Understanding the effects of country-of-origin on consumers' evaluation of products may signify the success or fail of any marketing program. To do that, research on the topic needs to be done considering what the literature offers and what has been done in the past. The classification here purposed will advance the knowledge in the area exposing in a snapshot different elements of the phenomena and offering a better perspective on possible ways to research country-of-origin.

The amount of studies scrutinized throughout of this paper is extensive. Tables presented help to synthesize the concepts. What follows introduces a classification of country-of-origin studies, next explains what is termed foreground studies of the areas along with each of its major groups, and ends with some related comments.

Country of Origin

In general, the country-of-origin affects consumer's product evaluation [Bilkey & Nes, 1982] since consumers evaluate a product considering information cues available [Kaynak & Kara, 2002]. As consumers in general tend to be less familiar with products of foreign origin [Huber & McCann, 1982] the country-of-origin is also found to be one of those cues. Country-of-origin is an extrinsic product cue, a class of intangible traits including product's brand, price, and warranty [Cordell, 1992]. Country of origin refers to "buyer's opinions regarding the relative qualities of goods and services produced in various countries" [Bilkey, 1993, p. xix].

Classification of the Studies

Probably the seminal work by Schooler [1965] can be considered as the first-ever published research of country-of-origin [Papadopoulos, 1993]. His study, made in the Central American Common Market (Costa Rica, Guatemala, El Salvador, and Mexico), analyzed the preconceived images of products on the bias of national origin. As Mexico was not then member of the Common Market, Schooler used it as a control group. In his investigation, he considered the regional jealousies, fears, and animosities as aspects with a specific weight in consumers' product evaluation. Even though the analyses are simple, the conclusion is that there are significant differences in the evaluation of identical products using labels with different country names.

The "Made in" label seems to have a significant impact on the consumers' product evaluation. Morello [1993] mentions the "Made in" concept is used since XIX Century as protectionist measures identifying products from foreign origin. The use of labels as origin identifiers is a common practice employed by companies of various nationalities in domestic and international marketing along with many governments whose regulations establish the obligation of declare the product's country of origin. Indeed, the World Trade Organization (WTO), pursuant to the principles decreed in the Uruguay Round's "Agreement on Rules of Origin," considers the country-of-origin marking as essential for global markets. Thus, we can think that the claim made by Dichter [1962] "The little phrase 'Made in . . .' can have a tremendous influence on the acceptance and success of products . . ." [pp. 116] is noteworthy. The "Made in" indication is one of the substitute or surrogate indicators (Cattin, Jolibert, and Lohnes, 1982) consumers have learned to use when there are missing cues; it has also been called by several authors as "stereotype" or "stereotyping" [c.f. Bannister & Saunders, 1978; Chasin, Holzmueller, & Jaffe, 1989; Khanna, 1986; Maheswaran, 1994; White & Cundiff, 1978; White, 1979] which exists and can influence people's behavior [Papadopoulos, 1993]. As a multifaceted construct with facets clearly interpretable [Parameswaran & Pisharodi, 1994], country-of-origin is potentially a powerful variable that can be used as a competitive business tool [Kaynak & Kara, 2002].

The country-of-origin's stream of research is classified in two categories introduced in this paper, foreground studies and background studies, subdivided into several major groups (see Table 1). Both of the categories contribute to the advancement of consumer behavior knowledge in its own right. This paper details the foreground studies, while the background studies and holistic and other relevant studies are developed in Wise and Cobas-Flores (Forthcoming). Table 1 includes the foreground studies with four major groups which approach country-of-origin effects, while the three major groups of background studies use country-of-origin as a basis for the research. For this classification, at least 99 studies were categorized representing a substantial part of the total research in the area.

The different approaches used to study the effects due to the country-of-origin examine product considering several areas of research. These areas of research are the four major groups here found (see Table 1): (I) Research in Marketing, (II) Construct Decomposition, (III) Cross-Cultural/National generalizability, and (IV) Research in Related Areas. Next, a description of each of them follows.

TABLE 1
CLASSIFICATION OF COUNTRY OF ORIGIN STUDIES

Foreground Studies	Background Studies
I. Research in Marketing 1. Source/Origin countries 2. Consuming countries 3. Test products 4. Test products brand	I. Literature Reviews 1. Product-country of origin 2. Product-country image
II. Construct Decomposition III. Cross-cultural/national Generalizability Assessment of reliability	II. Consumer behavior using country-of-origin as a research frame 1. Cue utilization 2. Perceived risk 3. Attitude theory 4. First-mover advantage 5. Cultural orientation influences 6. Market entry 7. Belief-attitude model 8. Likelihood model 9. Brand effects/image 10. Event analysis
IV. Research in Related Areas 1. Stereotyping 2. Ethnocentrism 3. Animosity 4. Brand	III. Methodology and Theory Construction 1. Sampling 2. Surveyed method 3. Type of research 4. Model definition 5. Test of approach
Holistic and Other Relevant Studies	
Combined foreground studies with background studies	

Note. This classification in an expansion and extensive modification of Kaynak and Kara (2002) map of product country images literature (pp. 932).

Foreground Studies

I. Research in Marketing

This is probably the largest major group of the whole classification due to several marketing variables are well embedded in the country-of-origin. One of such marketing variables has to due with the source or origin countries of the products, i.e. countries from which products are originated. The second variable has to do with the consumers' nationality of the products, i.e. nationality of the interviewee. The third and forth marketing variables refer to the products and their brands respectively.

1. Source/origin countries.

The country of origin research has been done considering diverse regions of the world (see Table 3). Diverse interviewees expressed their opinions about products originated from different regions of the world located in almost all the continents. Only six out of the 99 scrutinized studies consider products originated from single countries. In all the cases, the "made in . . ." label was addressed. The selection of a single country seems to be rooted in the nature of the studies. Other three studies examined the perceptions of domestic products by nationals of the same countries.

The largest direct mention in the 99 studies scrutinized is first for Japan and then for the USA with 51 and 46 respectively. Of them, 64 studies mention directly either Japan or the USA, or both together as the sourced countries researched. Both countries are evaluated in 33 studies while 27 discuss products originated either form Japan or the USA. The main selection for the two countries as source of products is the classification of them as industrialized [Darling & Kraft, 1977]; developed [Okechuku, 1994] or major trade powers [Papadopoulos & Heslop, 1989]. Further factors have been pondered such as been major trading partners of another country [Agbonifoh & Elimimian, 1999; Chang & Kim, 1995; Jaffe & Martínez, 1995], between them [Chao, 1989; Han & Terpstra, 1988; Han, 1990] or have recognized their products and brands as similar or comparable [Ettenson, 1993; Goldberg & Baumgartner, 2002; Johansson, Douglas, & Nonaka, 1985; Nebenzahl & Jaffe, 1996]. While other studies do not mention any clear or specific reasons for their selection of sourced or originated countries [cf. Chinen, Jun, & Hampton, 2000; Gürhan-Canli & Maheswaran, 2000a; Insch & McBride, 1998, 2002; White & Cundiff, 1978], several are based on the selection made by previous studies [Agrawal & Kamakura, 1999; Cattin et al., 1982; Han, 1988; Maheswaran, 1994; Nes & Bilkey, 1993; Shimp, Samiee, & Madden, 1993; Zhang, 1997]. It is plausible to mention that Japan and the USA are both sourced and originated countries employed by many researches due to their importance in the world market, presence of brands and products in almost every marketplace. Maybe due to their perceived preponderance, products from many countries are compared to products from Japan and USA.

Selection of the sourced countries by researches considers diverse factors deemed in Table 2. Although in some cases the factors pondered to choose a sourced country lack of a clear specification, in others it is quite explicit. Many of these countries were chosen as sourced countries because the level of recognition of their products and brands presumably is low or because their products are among the least desirable [Ahmed, d'Astous, & Zouiten, 1993]. Conversely, Olsen & Olsson [2002] chose Denmark, Iceland and Norway because they were "... the three most important suppliers ..." [pp. 155] to Sweden over the last few years. The factor used to select a sourced country may be relevant to the perception of the consumers or due to the performance or geographical location of the country. Thus, the diversity of factors used, or the use of more than one, seems to be common in the selection of the sourced countries.

TABLE 2

MAIN FACTORS FOR THE SELECTION OF SOURCED COUNTRIES

1. Classification of the level of development: a. Industrializing or industrialized b. Developing or developed	2. Geographical location: a. East or West/Eastern or Western b. A continent or part of a continent
3. Trade Partners: a. Between two countries b. With a third country	4. Presence in the domestic market
5. Level of recognition of products and brands	6. Previous studies
7. Products from foreign countries	8. Selection by consumers in a pretest
9. Products from the home country	10. No clear reason
11. Classification of the level of development: a. Industrializing or industrialized b. Developing or developed	12. Geographical location: a. East or West/Eastern or Western b. A continent or part of a continent
13. Trade Partners: a. Between two countries b. With a third country	14. Presence in the domestic market
15. Level of recognition of products and brands	16. Previous studies
17. Products from foreign countries	18. Selection by consumers in a pretest
19. Products from the home country	20. No clear reason
21. Classification of the level of development: a. Industrializing or industrialized b. Developing or developed	22. Geographical location: a. East or West/Eastern or Western b. A continent or part of a continent
23. Trade Partners: a. Between two countries b. With a third country	24. Presence in the domestic market
25. Level of recognition of products and brands	26. Previous studies
27. Products from foreign countries	28. Selection by consumers in a pretest
29. Products from the home country	30. No clear reason

2. Consuming countries.

Researchers have used subjects from diverse countries while studying country-of-origin effects (see Table 3). Such a study requires individuals who express their opinion regarding products from one or several source/origin countries. Those individuals reside in what can be named consuming country. In general, researches explicitly name the nationality of the consuming countries' subjects though in some cases assumed the reader would realize it. For instance, Cattin et al. [1982] assert that the responders selected for the study were Directors of Purchasing of Industrial Firms included in the Fortune 500 and in the Europe's Largest Companies. Moreover, they claim "The English questionnaire was mailed in the U.S. with an American return envelope, while the French questionnaire was mailed in France with a French return envelope" (pp. 132) but failed to assert whether only responders from the U.S. and French were used. On the other hand, Han & Terpstra [1988] are more obvious specifying that "Non-US residents were excluded from the population . . ." (pp. 240). In this case, although the reader might deduce that the target population was U.S. residents, such conclusion is not directly specified. In a similar vein, Mort and Duncan, 2000 used a similar practice explaining "respondents who had lived in Australia for less than two years were excluded from the analysis" (pp. 843) letting the reader deduce that the sample were Australians indeed. However, some authors failed giving enough clues to identify properly the respondents' nationality [cf. Hong & Wyer, 1990; Gürhan-Canli & Maheswaran, 2000b; Maheswaran, 1994]. It is always convenient to mention explicitly the nationality of the sample used because its identification helps to understand properly the research results and their applicability.

The bases for selecting subjects from a particular consuming country seem to be situational for the specific research. Although the consuming country most researched is the USA, the presence of other developed countries is substantial as well as some developing countries. The selection of the consuming countries is driven yet by the sole characteristics of the study. Contrasting, the selection of eight consuming countries (six developed and two developing ones) done by Papadopoulos and Heslop [1989] lacks of an explicitly explanation for the bases of such choices. However, Roth and Romeo [1992] collected data from three consuming countries (two developed and one developing) explaining the cross-nationality different effects country-of-origin may have on consumers from various countries as the basis for such selection. The two developed countries selected by Johansson et al. [1985] as comparable samples may have a similar consequence. Interestingly enough, the choice made by Khanna [1986] included five consuming countries (one developed and four developing ones) of a judgment sample of firms substantially involved in import/export operations of the specific products researched (see a partial list in Table 4) in the Indian market. Khanna asserts to explain an apparent sound basis for his selection. Nevertheless, in general, the selection of the consuming country seems to lack of other arguments than to be propelled by the characteristics of the analysis attempting to accomplish.

TABLE 3

AMOUNT OF SOURCE/ORIGIN COUNTRIES STUDIED USING THE CONSUMING COUNTRY

Consuming Country	Source/Origin Countries	Consuming Country	Source/Origin Countries	Consuming Country	Source/Origin Countries
USA	72	Russia	7	Philippines	4
Australia	18	Poland	7	Korea	4
Canada	16	Finland	7	India	4
Netherlands	13	Japan	6	Hong Kong	4
Mexico	9	Nigeria	5	Guatemala	4
Ireland	9	Greece	5	Austria	3
Hungary	9	Great Britain	5	Turkey	3
Germany	8	Thailand	5	Israel	3
France	7	Singapore	4	China	3

3. Test products.

Researchers have employed a plethora of products while studying country-of-origin. Those products range from general to specific goods covering services and concepts (see Table 4). Moreover, one research even used a fictional product [cf. Chen & Pereira, 1999]. Many studies analyzed several products; often, only one product was used. For instance, Lim and O'Cass, 2001 sought to understand the role of origin information on consumer perception of brands utilizing fashion clothing as the test product. They allege the use of that particular sector due to its large number of successful global brands. Similarly, Crawford and Lumpkin [1993] focused on the specific apparel sector for two reasons. First, apparel appears to be a major category involving developed and developing countries. Second, apparel seems to have been the subject of major advertising campaign showing either the superiority of products made in the USA or the patriotism of buying such products. Furthermore, Hester and Yuen [1987] questioned the actual apparel consumer behavior due to the apparel import statistics showed an accelerated trend to growth and different surveys concluded that most people preferred clothing made in their country. The use of other products is also found in the studies of country-of-origin.

Some other products seem recurrent by researchers while studying country-of-origin. Automobiles (some authors use the term cars instead), TVs, VCRs and other appliances and products for personal use are among them. Johansson et al. [1985] examined the interaction of nationality and other demographic variables of respondents with familiarity and experience with specific products and brands. To accomplish that, they needed a product class as comparable as possible in terms of product variants in the two countries surveyed. Their “natural choice” (pp. 390) were compact automobile models because they could found similar foreign makers with very similar models in both countries, the USA and Japan. Han and Terpstra [1988] decomposition of the country-of-origin construct examined automobiles and TV because these products are frequently bi-national and are relatively well known to the average consumer. They sought those characteristics to research the decomposition of the country-of-origin construct into more simple concepts since the item’s brand name was one of them. In a similar vein, Ahmed and d'Astous [1996] selected automobile and two other products (shoes and TV) to “allow the generalization of results” (pp. 100) and based on “their financial risk, technological complexity, complexity of purchase task and personal involvement” (pp. 100).

The selection of the test products researching country-of-origin seems to comply with particular factors of the research objectives. While the analyses of products range from goods to services, few studies used concepts as test products. In general, researchers have solid bases for the examinations of particular products despite few others mention their reasons. The variety of products used is substantial. Products diversity is ample, from personal (as discussed above) to industrial use. The presence of the country-of-origin effects on the subjects’ evaluation appears to be involved with a wide range of products.

TABLE 4
DETAILS OF THE CLASSIFICATION OF PRODUCT-COUNTRY OF ORIGIN STUDIES: TEST PRODUCTS

Goods	
Advertising, Cigarettes, & Movies	Goldberg and Baumgartner, 2002
Apparel/Clothing	Crawford and Lumpkin, 1993; Hester and Yuen, 1987; Lim and O'Cass, 2001
Automobiles	Ahmed et al., 1993; Durvasula et al., 1997; Erickson et al., 1984; Heimbach et al., 1989; Johansson et al., 1985
Automobiles & Blenders	Parameswaran and Pisharodi, 1994
Automobiles, Beer, Bicycles, Crystal, Shoes, & Watches	Roth and Romeo, 1992
Automobiles, Calculators, Cameras	Parameswaran and Yaprak, 1987; Yaprak and Parameswaran, 1986
Automobiles, Cameras, & Maxi Pads	Hong and Toner, 1989
Automobiles & TVs	Han and Terpstra, 1988; Han, 1989, 1990

Automobiles, Shoes, & VCRs	Ahmed and d'Astous, 1996
Bicycles & Typewriters	Maronick, 1995
Blend of several fruit juice & Fabric (beige)	Schooler, 1965
Buses	Stewart and Chan, 1993
Car Radio/Cassette Players & TVs	Okechuku, 1994
Cars/Spare parts, Electronics, Products-in-general	Agbonifoh and Elimimian, 1999
Chile Salsa & Potato Chips	Almonte et al., 1995
Clock Radios, Microwave Ovens, & Razor Blades	Heslop et al., 1998
Dictation System, List Trucks & Machine Tools	White and Cundiff, 1978
Food Products	Bailey and Gutierrez de Pineres, 1997
Foreign products	Damanpour, 1993
Headache tablets & TVs	Mort and Duncan, 2000
Jeans, Sneakers, Stereos, & Watches	Iyer and Kalita, 1997
Luggage & PCs	Zhang, 1997
Mountain Bikes	Gürhan-Canli and Maheswaran, 2000a
PCs & VCRs	Hong and Wyer, 1989, 1990
PCs	Maheswaran, 1994
Seafood	Olsen and Olsson, 2002
Shirts & TVs	Zhang, 1996
Stereo Systems	Maheswaran, 1994
Telephones & TVs	Lim et al., 1994
TVs	Ettenson, 1993; Li et al., 2000
TVs, Athletic Shoes, & Mountain Bikes	Insch and McBride, 1998, 2002
Services	
Air Line Industry	Bruning, 1997
University	Webb and Po, 2000
Concepts	
Countries as Products	Wee et al., 1993
Buy Campaign	Fenwick and Wright, 2000
Fictional Product: The personal tutor	Chen and Pereira, 1999
Made in China products	Brunner et al., 1993

4. Test products brand.

One extrinsic characteristic regularly attached to the test products researching country-of-origin is their brand (see Table 5). However, not every study uses brands in their analysis. Many of them test the products without considering any brand. For instance, the focus in many cases is on the evaluation of the origin of the products regardless of their brand [cf. Bailey & Gutierrez de Pineres, 1997; Insch & McBride, 1998; Olsen & Olsson, 2002; and Schooler, 1965 among others]. Many other times, the brand is linked to a country-of-origin and researches examine the products using a particular brand. From the initial list of 99 studies investigated, 20 use brands for the test products. Interestingly, the large amount of brands is from automobiles followed by TVs and VCRs. As mentioned earlier, researchers have employed such products given the consumers familiarity with them.

TABLE 5

DETAILS OF THE CLASSIFICATION OF PRODUCT-COUNTRY OF ORIGIN STUDIES: TEST PRODUCTS BRAND

Automobiles	
Audi 400, BMW 320i, Chevrolet Citation, Datsun 200SX, Ford Mustang, Honda Accord, Mazda 626, Plymouth Reliant, Toyota Celica, Volkswagen Rabbit	Erickson et al., 1984

Audi 4000 or Audi 80, BMW 320i or BMW 318i, Chevrolet Citation, Datsun 200SX or Nissan Sylvia, Ford Mustang, Honda Accord, Mazda 626 or Mazda Capella, Plymouth K-Car, Toyota Celica, Volkswagen Rabbit or Golf	Johansson et al., 1985
Chrysler Colt, Honda Civic, & Volkswagen Rabbit	Han and Terpstra, 1988
Fiat 28, Honda Civic, Volkswagen Rabbit	Parameswaran and Yaprak, 1987; Yaprak and Parameswaran, 1986
Volkswagen Jetta & Hyundai Stellar	Parameswaran and Pisharodi, 1994
Buses: Nissan, Mitsubishi, & Mercedes-Benz	Stewart and Chan, 1993
Calculators: Canon, Olivetti, Royal	Parameswaran and Yaprak, 1987; Yaprak and Parameswaran, 1986
Cameras: Canon, Leica, Ferraria	Parameswaran and Yaprak, 1987; Yaprak and Parameswaran, 1986
Canned Food: Del Monte, Green Giant, Libby's, & Swift	Gaedeke, 1973
Car Tires: Elkem & Goodyear	Nes and Bilkey, 1993
Cigarettes: Marlboro	Goldberg and Baumgartner, 2002
Drills: Algot & Black & Decker	Nes and Bilkey, 1993
Hair Dryers: Tekam & Conair	Nes and Bilkey, 1993
Microwave Ovens	
GE & Sony	Nebenzahl and Jaffe, 1996
Grundig & Sanyo	Nebenzahl and Jaffe, 1993
Radios: General Electric, Motorola, Sears Solid State	Gaedeke, 1973
Shoes: Florsheim, Pfister, Thom McAn	Cordell, 1992
Slacks: Penny's Towncraft	Gaedeke, 1973
Stores[a]: Yellow, Trans Canada, & Simard and Voyer	Ahmed and d'Astous, 1996
Toys: Mattel	Gaedeke, 1973
TVs	
General Electric, Grundig, JVC, & Samsung	Han and Terpstra, 1988
Gold Star	Chao, 1989
Magnavox, Sylvania, & Zenith	Gaedeke, 1973
Philips, Samsung, Sony, & Zenith	Okechuku, 1994
VCRs	
GE & Sony	Nebenzahl and Jaffe, 1996
GE, Samsung, & Sony	Ahmed and d'Astous, 1996
Gold Star	Chao, 1989
Grundig & Sony	Nebenzahl and Jaffe, 1993
Watches: Seiko, Tempomax, Timex	Cordell, 1992

Note: a. Stores names were used as surrogate for shoes.

II. Construct Decomposition

The importance of this major group in the classification of Country-of-origin (COO) studies (see Table 1) is meaningful to the advance in the understanding of the country-of-origin effects. As the research in the area matured, the country-of-origin construct began to be decomposed into more specific elements. The studies here included represent that stream of research. The decomposition of the country-of-origin construct has one of its examples in a product branded in one country while actually is manufactured or designed in another. Although Parameswaran and Yaprak [1987] mention some facets of the country-of-origin construct later taken by Parameswaran and Pisharodi [1994], their research purpose was not to decompose the country-of-origin construct Probably, Han and Terpstra, 1988 are the first to explicitly scrutinize the decomposition of the construct. They concluded that both source country and brand name affect consumer perceptions of product quality. Later, Chao [1993] used the term "hybrid products" refereeing to products made in one country, designed in another and sold in a third one. His study analyzed country of assemble (COA) and country of design (COD) addressing the multidimensionality nature of the construct. The results showed that COA had not significant impact on design quality perception while the COD influenced the perception of quality. Chao's study demonstrated the value of dimensionalizing the country-of-origin construct.

Country-of-origin seems to have several dimensions, but some of them appear to be on the image of the origin country. Attempting to develop and refine a scale for measuring country-of-origin image, Parameswaran and Pisharodi [1994] identify several facets of country-of-origin image. Two of those facets, general country attribute (GCA) and general product attribute (GPA); the third facet was specific product attributes (SPA). The three facets were previously identified as two by Yaprak and Parameswaran [1986] while introducing a deductive, paradigm-integrative approach to study country-of-origin.

It is plausible to delineate the domain of country-of-origin construct in a different fashion as Samiee [1994] attempted. Examining the customer evaluation of products, Samiee [1994] conceptualized three constructs: country-of-origin, country-of-manufacture (COM), and country stereotyping effects (CSE). The introduction of the CSE is done by Samiee due to the then scant research of country-of-origin to form inferential beliefs. He asserts that subjects exposed to country-of-origin cues modify their attitudes toward products. Despite the deconstruction of the country-of-origin is never mentioned by Samiee, al least two of the dimensions examined (country-of-origin and COM) correspond to what others researchers have considered as part of the country-of-origin construct.

The growing literature findings on the decomposition of the country-of-origin construct have kept suggesting the multi-dimensionality of the concept. Ahmed and d'Astous [1996] undertook the division of it into at least two cues: country of design (COD) and country of assemble (COA), following Chao [1993], adding brand name as one of the additional information cues. Brand name was added because seemed often been associated with the brand's corporate headquarters country location. Thus, brand name, COD and COA were argued to be extrinsic cues used by consumers to evaluate products. The study concluded that apparently consumers make a distinction between the COD and COA cues which seem to perform strongly than brand cues; also, it was suggested to include country of parts (COP, researched later by Insch and McBride, 1998). In the meantime, Iyer and Kalita [1997] studied "bi-national products" (pp. 8) bearing a brand name associated with one specific country while its manufacture was done in a third country. They deemed that the country-of-origin construct has two parts, the "Made in" image (country-of-manufacture or COM) and the "country-of-brand origin" (COB) image. Apparently, COM is used in the same fashion as the COA introduced earlier by Chao [1993]. The study tested the impact of both cues on consumer's perceptions of quality, value and wiliness to buy bi-national products. Again, it was found that COM and COB are factors considered by consumer's evaluations of quality and value. Moreover, such factors appear to have a particular effect absenting brand names.

Following the trend of the literature, additional research was further added to the deconstruction of the country-of-origin construct. Both studies by Insch and McBride [1998, 2002] include the same three components of the construct, country of design, country of assembly and country of parts. Country of design (COD) is defined as the country where the product was conceived and engineered. Country of assembly (COA) is the country where most of the product's final assembly was done. Moreover, country of parts (COP) represents the country where the majority of the materials used in the product come from and/or the components parts are made. As expected, the results evidenced that the three components have an effect on consumers' perception of the product overall quality. Finally, Li et al. [2000] examined the effects of global sourcing location and some related factors on consumer's evaluations of product quality decomposing the country-of-origin construct into COD, COA and country-of-corporation (COC).

The decomposition of the country-of-origin construct contributes to the study of consumer behavior presumably simplifying its multidimensionality. However, some of the dimensions proposed seem to have more than a single unidimensionality (for a full list of the components discussed before see Table 6). GCA, GPA, SPA and CSE can be included in that class. In a similar vein, while at least one component (USA branded) specify one country, the rest of them might related to more than one country, i.e. can be used for most of the origin or source countries. Although some authors have used different tags to designate equivalent dimensions, probably COA, COB, COD, COC and COP will prevail for future research. It general, it can be said that there are more advantages in the use of multi-items compared with a single-item to measure a single construct [Churchill, 1979]. Despite the aforementioned, the proliferation of research using country-of-origin continues and seems endless as more studies include diverse aspects of relevance in countries sparse researched.

TABLE 6
DETAILS OF THE CLASSIFICATION OF PRODUCT-COUNTRY OF ORIGIN STUDIES:
CONSTRUCT DECOMPOSITION

Country stereotyping effects (CSE)	Samiee, 1994
Country-of-assemble (COA)	Ahmed and d'Astous, 1996; Chao, 1993; Insch and McBride, 1998, 2002
Country-of-brand (COB)	Iyer and Kalita, 1997
Country-of-corporation (COC)	Li et al., 2000
Country-of-design (COD)	Ahmed and d'Astous, 1996; Chao, 1993; Insch and McBride, 1998, 2002
Country-of-manufacture (COM)	Iyer and Kalita, 1997; Samiee, 1994
Country-of-origin (CO)	Samiee, 1994
Country-of-parts (COP)	Insch and McBride, 1998, 2002
Foreign branded	Han and Terpstra, 1988
General country attribute (GCA)	Parameswaran and Pisharodi, 1994
General product attribute (GPA)	Parameswaran and Pisharodi, 1994
Specific product attribute (SPA)	Parameswaran and Pisharodi, 1994
USA branded	Han and Terpstra, 1988

III. Cross-Cultural/National Generalizability

Relevant to the study of COO is the cross-cultural/national generalizability of the findings included in this major group. It can be said, that by definition, all studies considering COO have a cross-cultural/national elements since at least two countries are analyzed, the source and the consuming countries. However, studies here considered attempted to compare results from different cultures and/or nations crucial to make meaningful comparisons across them [Malhotra, Agarwal, & Peterson, 1996]. Such research has used culture or a nation as its main independent or dependent variable but not as an extraneous and/or residual variable [Nasif, Al-Daeagj, Ebrahimi, & Thibodeaux, 1991]. Generalizability refers to the degree to which a study based on a sample applies to the population as a whole [Malhotra, 1999]. In general, the term reefers to the classical theory of generalizability where there is an emphasis on parallel tests assuming that measurement conditions are equivalent [Rentz, 1987]. The CETSCALE was initially developed with the intention “to measure consumers’ ethnocentric tendencies related to purchasing foreign- versus American-made products” [Shimp & Sharma, 1987, pp. 281]. However, the limitation of the generalizations beyond the samples and countries have been noted by Netemeyer et al. [1991].

IV. Research in Related Areas

Studies using COO as a base to undertake related studies are found in this major group of foreground studies. From the studies investigated, four related areas have been detected (see Table 1). Stereotyping refers to consumers common notions about people in other countries [Khanna, 1986]. Furthermore, stereotypes can be schemas formed on less objective bases such as attributes that are inferred, context dependent, and vary across the consumers’ classification of products [Maheswaran, 1994]. Also, product country images have been considered as product country stereotypes [Almonte et al., 1995]. Ethnocentrism can be defined as the beliefs to view purchasing foreign products as wrong because it hurts the domestic economy, causes job loss, and is unpatriotic [Durvasula et al., 1997;

Shimp & Sharma, 1987]. Animosity is defined by Klein, Ettenson, and Morris [1998] "as the remnants of antipathy related to previous or ongoing military, political, or economic events" (pp. 90) affecting consumers' purchasing behavior of products originated from a country with that resentments. Although brand is a very well known concept in marketing, its use with COO is commonly seen. Under that conception, brand is envisaged as an identification of a product to differentiate it from competitor offerings. However, recent studies use country of origin of brands as part of the research question. All the research areas encompassed in this group have particular contributions to the advancement of COO knowledge and help to understand better their effects in the international marketplace. In general, the studies included in this major group use country-of-origin as a basis to understand other phenomenon.

The related areas of research using COO as a framework help to explain several lacunas observed in international marketing. In many regards, it is possible to elucidate that the related areas here considered are not unique whereas the field is fertile. Similarly, these related areas of study are not exclusive and can be seen in other marketing studies (i.e. brand studies). It can be expected the inclusion of more related areas to the study of the COO effects as the field progresses.

Conclusion

The purpose of this paper was to introduce a classification of the country-of-origin research. The classification includes areas that cover aspects used by researchers while studying country-of-origin directly or as a base or support for other studies. As one of the classes, foreground studies have been scrutinized resulting in four major groups. Despite the generalized finding that country-of-origin is an effect present in almost every consuming country, there is still research needed to understand many of its effects on different consumers. Studying country-of-origin needs products originated in either the domestic market or international. The sourced countries studied represent a good amount of the countries. On the other hand, the consuming countries researched are only a small part having the opportunity to continue using them or adding other countries as the globalization reaches them. Many countries form Central and South America, Africa, and Asia are in that case.

As the globalization continues, the persistent presence of products designed, manufactured, produced, branded, and or with parts from different countries opens a good opportunity to research hybrid products. Additionally, the brands and store nationality could be added to the process. Although most of the researchers recognize the effects of country-of-origin on consumers' behavior, their generalization and specific effects are still controversial. Despite the large number of studies done, the country-of-origin effect is somehow generalizable, but much is still needed regarding the direction or intensity. Similarly, country-of-origin can be used to research related areas where much is yet needed. Understanding stereotyping, ethnocentrism, animosity and brands opens a vast door. Notwithstanding some of these have been studied extensively such as brand and stereotyping, the other two are relatively new.

Managers and marketers are each day more aware of the needs and perceptions of the consumers. Firms are investing and producing overseas. Then, they need to discover the best way to satisfy customers knowing their attitudes, perceptions and behavior. It seems that such tendency will draw the difference between survival and failure.

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Exploiting Managing Relationships with One's Customers (CRM) for Improving the Competitive Ability of Manufacturers in Stagnating Markets

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Abstract

On the basis of a description of the essence and functions of Call Centres and Marketing Communications as applied in Z ELEKTRO, the intention was to carry out some research that would enable the extrapolation of conclusions as to the role these factors play in the attainment of competitive advantage and competitive capabilities. The research study was oriented on tracking changes in the management of Pre-Sales, Sales, and Post-Sale activities – and furthermore, on determining whether CRM is understood as an entrepreneurial philosophy by the enterprise as a whole, or only by the Commercial Sales Department. The author eliminated all other external and internal influences in order to be able to precisely determine the actual contribution made by marketing activities towards increasing the competitive ability of this enterprise.

Introduction

Competition on global markets today is an ever increasing phenomenon. The sale of products or services is evermore difficult, and enterprises are therefore forced into seeking new ways of persuading potential customers that their product is the best. Successful managers, including Mr. Jan Mühlfeit – the Managing Director of the Czech branch of Microsoft, point out that the basis of successful sales is grounded in constant cooperation with previously acquired customers. Our research endeavours at this stage were therefore oriented towards discovering the actual level of the relationship between Sales and customs in Czech enterprises and its influence on increasing Sales figures.

In periods when there is a surfeit if customers, and when it is not difficult for an enterprise to gain additional ones, mean that the pressure to take good care of one's customers is low. The significance of CRM grows in direct proportion to increases in competition and the correlated difficulty in gaining new customers and maintaining existing ones. The perception of the term CRM (Customer Relationship Management) has stabilised its meaning in the sense of an entrepreneurial strategy for the selection and management of the most "valuable" relationships with one's pro customers. CRM is therefore, an entrepreneurial philosophy and company culture oriented towards its customers, and which supports effective marketing, commercial and service processes. CRM is the means in which an enterprise behaves to its customers, how they maintain their relationship with those customers, and how they exploit these relationships to the mutual benefit of both themselves and their customers.

This case-study is concerned with the implementation of CRM in purely Czech commercial enterprises, and serves to demonstrate certain positive and even negative aspects regarding their approach and attitude towards their customers.

1. This analysis of the contemporary approach to customers investigated the following aspects:

a) Directly within the Z ELEKTRO Company: In the course of Departmental meetings held within the Commercial Sales Department; tracking the work of the telephone operators working within the Call Centre; in the course of operator selection procedures – drawn from the ranks of students of the Faculty of Management and Economics, UTB in Zlín; and the evaluation of printed materials prepared for distribution as well as the selected means of distribution.

b) External to Z ELEKTRO: It verified the quality of the work of the telephone operators by means of mock calling-in as well as verifying reactions to e-mail messages; it tracked the reliability of the distribution of special offer/discount catalogues to personal mailboxes; and verified the quality of ordering and collecting goods directly from the enterprise's stockrooms as well as the ordering and delivery of goods from outside the environs of Slain itself, within a radius of cca 50 km from the town.

c) It also analysed discussions of the outcomes of the investigations with the management of this enterprise, as well as tracking interviews held with the company's personnel employed in the Call Centre. Further, it considered both wholesale and retail outlets in the course of purchasing goods to meet personal needs and purchases at a distance.

2. The setting-up of the Call Centre

Z ELEKTRO reacted to increasing competition seen after 1995 among purveyors of electrical consumer goods on the Czech markets by establishing its PROTON customer care centre (Call Centre). As soon as customers receive the Monster (special, extended), PROTON Catalogue, they should discover upon reading the basic information it contains that they have at their disposal a Customer Call Centre, in which professionally trained Sales staff are able to advise them and to respond to any potential questions pertaining to the goods included in the catalogue, and that this service is provided on a "toll-free" telephone number. Furthermore, the Sales staff organises the deliveries of the selected goods to the nearest (to the customer) retailer's Salesroom, or eventually, they will organise its delivery C.O.D. (Cash on Delivery), or alternatively, will arrange appropriate hire-purchase contract details.

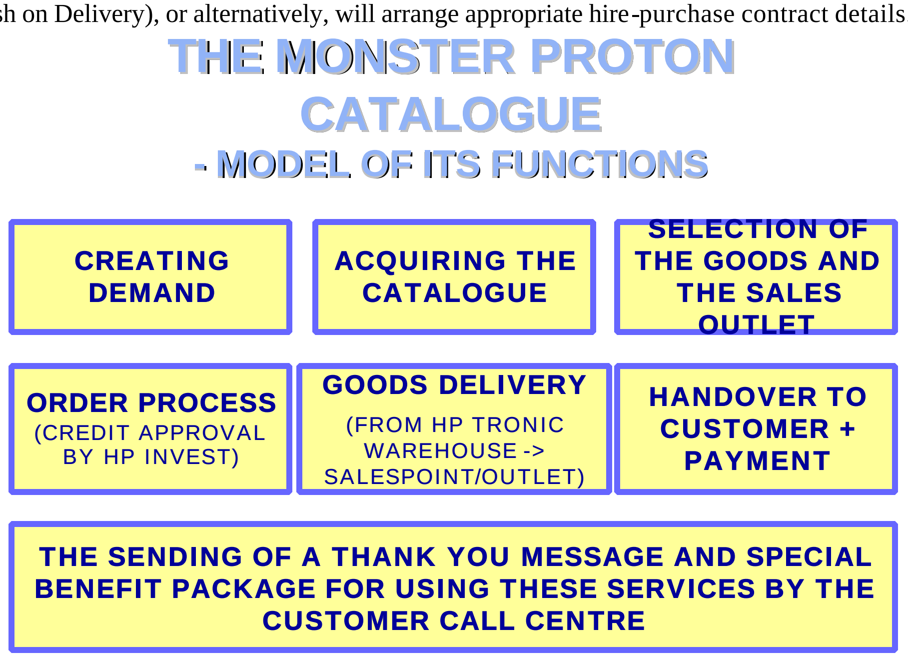

FIG. 1: THE APPEARANCE OF THE **M**ONSTER **P**ROTON **C**ATALOGUE (**MPC**)

Full coloured print on high-quality paper.

- 260 pages.
- 1,500 products.
- Product range – electronic and electrical goods, telecommunications products, photographic products, large and small-scale household electrical goods.
- Arranged according to product type and parameters.
- Advisory service and description of the system.
- List of contact details and addresses of retail outlets.

A further task of the employees of the Call Centre is to elicit the maximum information possible from customers and to register the customers´ product interests, whether or not they have already purchased anything from the company, their domicile, their educational background, type of employment, and eventually – what their social standing is, or how many children they have. It goes without saying, that all of this data is recorded only with the consent of the customer. The whole of the working collective of the Call Centre are supported by a specialised software package and computer network, which not only enables on-line searches, but also allows the checking of the current availability of products in stock in Z ELEKTRO´s warehouses, as well as the stock positions of the associated retail outlet network.

The decisive key to the quality of the services provided by the Call Centre is, of course, the people employed there. In the course of the selection procedure for appropriate candidates to work as telephone operators in this Tele-Marketing field, a basic principle held is that the first contact must take place over the telephone. This is because the fundamental attributes requisite for working as a telephone operator are their voice, its modulation and tone, level of courtesy, clarity of comprehension, delivery speed, and pronunciation. Other specific requirements for this field are, for example, previous experience with Tele-Sales, the ability to carry out so-called "Cold-Calling" (i.e. calling up a person who is not anticipating such a call), detailed product knowledge, or even such a prosaic skill as the ability to fluently communicate with someone over the telephone while simultaneously taking notes. It goes without saying that PC skills are essential, as are an eventual knowledge of the specialised SW packages used.

The basic aim of the PROTON project: Is to attract to its retail salesrooms those customers who would otherwise have ended up going to other market segments (i.e. Hypermarket chains like Makro, Triangl, Elekrocity, etc.)

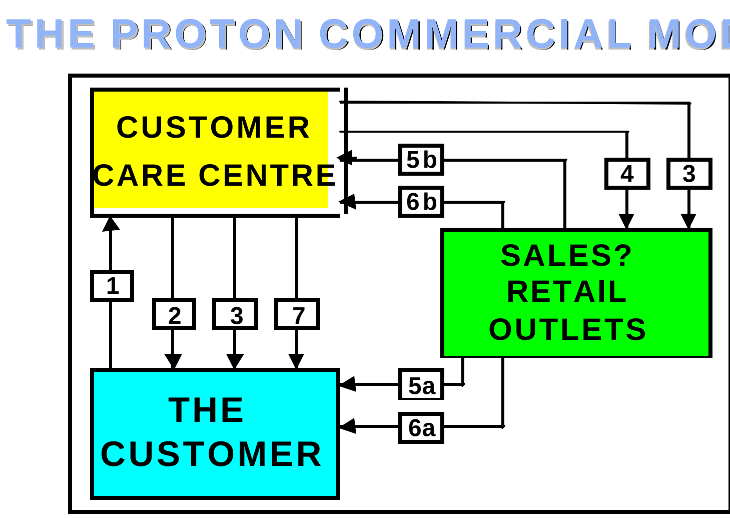

FIG. 2: THE PROTON COMMERCIAL MODEL

0. Demand Creation.
1. The customer contacts the PROTON **C**ustomer **C**all **C**entre (**CCC** => **3C**). Contact is via e-mail or toll-free call lines on the basis of a reaction to the stimuli – i.e. the catalogue, other advertising).
2. The **3C** collects data from the customer, enters this into the database, and accepts/creates actual orders.
3. The **3C** allocates the customer a concrete person who will be in contact with them from the „bricks and mortar“ sales outlet (i.e. **C**oncrete **C**ontact **P**erson => **CCP**)
4. The **3C** informs the **CCP** about the customer (and in parallel, checks on the availability of the goods).

5a The **CCP** contacts the given customer and agrees an appropriate solution to the customer's requirements.

5b A copy of the "contact" (news about such a contact) is sent by the **CCP** to the **3C.**

6a The **CCP** resolves the customer's requirements.

6b The **CCP** passes on a report to the **3C** about the way in which and deadline for the resolution of the customer's requirements.

7. The **3C** contacts the customer again, and asks them whether they were satisfied with the service provided, or whether they have any comments or suggestions to make, and offer them the Benefit Package, or eventually, the PROTON Guarantee.

Their Motto is: "There's no need to come to us, we will bring the goods to you, plug them in, demonstrate their functions, and we even take away the old product(s), or offer you a "Trade-in/Buy Back" scheme."

Evaluation of the functioning of the Call Centre

In the course of tracking the working practices of the operators directly within the Call Centre, they demonstrated their ability to react rapidly and promptly to enquiries as well as to complaints from potential customers. Customer dissatisfaction was mainly due to the delivery deadlines of the **M**onster **P**ROTON **C**atalogue (**MPC**). The customers had ordered one, but delivery (**C.O.D**. = **C**ash **O**n **D**elivery) depended on a sufficient number of orders being received beforehand. The fault lay in the delay caused by waiting for a greater number of orders in order to take advantage of discounts for bulk postage offered by the Czech Postal Services. In 2002, the catalogues were sent out by Recommended Letter accompanied by a pre-printed Postal Order for its payment. Approximately 50% of the customers paid. It is recommended that the **MPC** (catalogue) be sent out free-of-charge, in order to reduce administrative complications.

On conclusion of the telephonic verification of the working practices of the Call Centre, I can state that the practices of the operators were up to the anticipated level. My comments and recommendations were directed to the loudness of the music on the call-waiting function, as well as to its (inappropriate) orientation (it was clearly "Techno"). My suggestions that this music be more main-stream were accepted, since the clients of the Call Centre do not in the main belong to the adolescent generation. Responses to e-mail messages took circa one hour.

The free Z ELEKTRO flyers were delivered to my classic mailbox in good order. I was not however, contacted by letter (Direct Mail), even though I am a Z ELEKTRO cardholder.

3. Ordering and picking up goods from the company's warehouses

I expressed my interest in an electrical appliance to meet the needs of my family in the Call Centre itself. The employees were very willing and capably advised me as to the appropriate selection and assured the reservation of the goods directly from the Warehouse. At the warehouse, they processed my order and gave me the goods despite this taking place at the same time when they had to organise large deliveries for some of their larger customers. The invoicing and filling out of the Guarantee was performed in due order.

A disadvantage though, is the location of this warehouse within the environs of the (former) SVIT site. The customer is forced to prove their identity to the Security personnel several times, and to detour round private lots. Getting to the building, which is easily visible from outside the perimeter is complicated. Z ELEKTRO have leased two floors of this building, the others are not exploited by the building's proprietors. I do not consider it to be particularly felicitous that, on a building that is clearly visible from the main thoroughfare of Zlín, (i.e. Tr. T. Bata; Tr = Avenue), and directly below the Z ELEKTRO logo and billboard, hangs an advertising panel saying "Rooms To Rent". To the uninitiated, this advertising panel could cause the impression that Z ELEKTRO have got into financial difficulties, and have had to rent out floor space that they might have been using themselves at some time in the past.

4. Ordering and picking up goods from outside Zlín

After my positive experience with the practices of Z ELEKTRO, I ordered an automatic washing machine for my parents, who live in a village some 50 km outside Zlín. This was delivered by an employee of a transport company the day after they had received my order. However, he refused to carry it to the requisite place in the house where it should have stood, and equally resolutely refused to plug it in and connect it up, on the grounds that his job was simply to deliver the goods. I had to got here myself a day later, and with the assistance of a schoolmate, carry the washing machine to its proper location, and take away the old one. Then, I had to spend a lot of time studying the connectors of the washing machine, since this was the first time in my life that I had done such an activity.

5. Verification of the validity of the scientific method and outcomes

The chosen methods were shown to have been valid. The opportunity to be able to be engaged in the actual setting up of f the Call Centre, and at the inauguration and inception of its activities proved to be exceptionally advantageous to the research investigations. I had the opportunity of being acquainted with the conceptions and notions of the General Manager, and the fulfilment of the same directly within the enterprise as well as outside grounds of the enterprise. I consider the verification of the activities of the Call Centre by means of my own telephonic exchanges with them and their reactions to my email stimuli as being highly important. The practical verification of the introduction and implementation of the new CRM system within this enterprise was by means of the actual purchases from the company warehouse and the ordering of the automatic washing machine for a location outside Zlín.

6. Establishment of the hypothesis governing the level of approach and attitude to Z ELEKTRO`s customers and its verification in practice

In the course of formulating this hypothesis, I based myself on the preceding research conducted into the enterprise Z ELEKTRO in which it was determined that this company is situated on the borderline/interface between a transactional and a relational conception of entrepreneurial activity with a predomination of the elements of a relational approach.

The individual elements of both approaches are shown below as follows, and they are numbered as sub-hypotheses (1-7). In the course of the verification of the outcomes with the hypotheses, it will either be confirmed or else refuted whether the enterprise is noted for its predominantly relational approach.

TRANSACTIONAL APPROACH:	RELATIONAL APPROACH:
1. An orientation on “One-off” Sales.	An orientation on customers and maintaining them.

This hypothesis was confirmed in the case of large-scale customers. Customers who order goods from the Monster Catalogue are simply not contacted again. This error also holds true for owners of the Z ELEKTRO loyalty card.

2. A discontinuity in contacts with customers.	Continual contact or dialogue with one’s customers.

Continual dialogues are less likely to be led. There is an effort to communicate and to maintain key customer through the intermediary of the Commercial (Sales) Department. The reduced number of operators in the Call Centre does not enable the holding of continual dialogues with all of the customers.

3. An emphasis on the characteristics of the product.	An emphasis on the customer’s perceived values.

This research was carried out in a commercial enterprise which has the possibility of influencing its product range, and thereby the characteristics of the products. Special offer leaflets are however oriented predominantly on price-led competition (price-cutting) rather than on the values perceived by the customer. This hypothesis was therefore refuted.

4. A short-term approach.	A long-term approach.

This hypothesis was only partially confirmed. For small-scale customers, a short-term approach holds true; a long-term approach only holds true for significant, large-scale customers.

5. Little emphasis on Customer Service.	Large emphasis on Customer Service.

This research study showed that the After-Sales Service is a great weakness for this enterprise. Everyday matters like connecting up the product, demonstrating its functions, and the carrying away of old, obsolete appliances is not included in contractual arrangements with the transporters. This hypothesis was therefore refuted.

6. Little effort to fully satisfy the customer’s expectations.	Great efforts to fully satisfy the customer’s expectations.

This hypothesis was not confirmed predominantly due to the incorrect approach applied by the employees of the contractual transport company or companies.

7. Quality issues are the domains of production department employees.	Quality issues are the domains of each and every employee.

This hypothesis was only confirmed in full for employees of the Call Centre and the warehouse in Zlín itself. As regards salespersons in the Z ELEKTRO chain, this is more-or-less true; for the contractual transporters, this does not hold true.

In aggregate, it is possible to state after evaluating the outcomes of the sub-hypotheses that Z ELEKTRO is situated on the borderline/interface between a transactional and a relational conception of entrepreneurial activity with a predomination of the elements of a transactional approach.

Therefore, the original hypothesis that a relational approach predominates was not confirmed, and that this was predominantly "by rights" due to the "services" of the contractual transport companies.

Conclusion

The establishment of a contact centre in the enterprise Z ELEKTRO is one of the first steps towards increasing the competitive abilities of this enterprise. It is necessary that this project be continuously evaluated and subsequently correspondingly corrected. An essential condition is a sustained endeavour to attain a "zero tolerance" level towards errors. The seeking out of errors should not however become a hammer dangling over the employees of the Call Centre; otherwise the employees will not identify themselves with the goals of this activity. The goal must be the complete satisfaction of the customer, who will make full use of the offered "Club" benefits and thereby will become a long-term customer of this enterprise.

The enterprise must realise that the relationship with its customers is not simply built by the employees of this enterprise who are already at the requisite level. Their best endeavours can simply be turned to dust by the employees of the contractual transport companies, who SIMPLY ONLY deliver the goods, and all the rest simply does not interest them.

The creation of a CRM system in this enterprise is not simply a momentary fashion issue, but the necessity to survive in a (highly) competitive environment. The customer's requirements over the last five years in the Czech Republic have escalated to a significant extent, and this trend will only continue.

Local enterprises are already feeling the pinch of an insufficiency of capable employees able to work in the Customer Services Department and are beginning to realise that they must orient their strategies more towards better recruitment practices, better training, and better reward systems for their (good) employees.

In the future, successful organisations will those that:

- Readily understand that customers have differing requirements for services.
- Segment their customer-base to a greater degree than is now the case.
- Establish the correct investment strategy for developing their human resources and technology-base.
- Ensure the provision of Top Quality services.
- Enforce Customer service as a component of the overall evaluation of their enterprise.

From the above-mentioned conclusions, it is clear that the employees of Z ELEKTRO know and observe the principles of courtesy, and approach the fulfilment of customers' requirements in a responsible manner. However, other employees in the frontline escape such controls, and these are those working for the contractual partners as transporters. The delivery and unloading of washing machines, freezers and fridges and getting them up and running is nothing unusual. Equally, the taking away of obsolete appliance is becoming an evermore-commonplace occurrence.

Z ELEKTRO are fully aware of the competition on the market with electrical appliances and goods, and are endeavouring to accommodate customers` requirements, and to enable the benefits of ordering from the comfort of one's own home with the assistance of catalogues and leaflets. In comparison with the best (in this field), it has been shown that their weakness is in their After-Sales Service.

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Entrepreneurial Identity and Personality Types

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Abstract

In promoting entrepreneurship, the importance of the personality of the potential entrepreneur is usually ignored. This study focuses on the question "What kind of entrepreneurship is appealing to business students?" Especially the students' personality as a predictor of entrepreneurial identity is concerned. Jungian-based Myers-Briggs Type Indicator was used to measure the personality types. The sample consisted of 283 students, who were rating those entrepreneurial identities that they found attractive or less attractive. Nineteen different types of entrepreneurial identities, e.g. businessman-, inventor-, co-operative- and team-entrepreneur, were possible to rate by the observations. The results indicated that business students in Finland would favor team-entrepreneur, trainer/consultant, manager, and businessman identities. By personality, each of the identities is favored or disfavored by quite different personality types. That is, when trying to focus on different educational systems, the results can be useful.

Introduction

There are a number of assumptions, beliefs and even cases of 'confident knowledge' about entrepreneurial attitudes, intentions and prerequisites, but in reality, knowledge about these matters is based more on suppositions than on real knowledge. At macro level, research should be used to examine the structural aspects of entrepreneurship to direct the development efforts in a proper way. At micro level, it would be appropriate to combine a survey on entrepreneurship potential of students, which partly explains the background and favors positive attitudes towards entrepreneurship or a wage-earner work culture. That is, on the one hand, contributing the development of entrepreneurship requires surveying existing entrepreneurial attitudes and entrepreneurship potential to know the starting points. On the other hand, developing entrepreneurship requires creating a positive cultural climate and structural prerequisites for entrepreneurship. It is possible, of course, to implement development programs separately especially at macro level, but development means are often 'a shot in the dark' if the starting point and the essential effect and cause relations are not known. At its best, a survey of entrepreneurship potential, and in this case the entrepreneurial identity of university business students, clarifies the components of entrepreneurship potential to understand the attitudinal climate and entrepreneurial readiness. Especially, the number of academic entrepreneurs has been alarmingly small in many countries, not least in Finland. Therefore, this study focuses on the entrepreneurial identity of university business students. [11]

There are several systems, projects and training courses to enhance new venture creation. There are results, too, but not very accurate knowledge about them. An entrepreneurship profile, based on survey of potential, serves for better planning and focusing of these activities. It is possible to identify special characteristics and target groups through this survey and thus direct development activities towards 'right' targets. Through considering entrepreneurial identities (e.g. in subcontracting, franchising, agribusiness), it is possible to focus research, training and other development activities for example on woman entrepreneurship, academic entrepreneurship, on so-called marginal entrepreneurship and rural entrepreneurship and more generally on micro and service entrepreneurship taking special characteristics into account. Entrepreneurship profiles can be exploited with their information about attitudes and facts for entrepreneurship education and for information, coaching and training focusing on special groups. [11]

Entrepreneurial Identity

When trying to explain entrepreneurship there have usually been two different aspects. The role of environment has been one of the key words to explain entrepreneurship. Other studies, instead, have focused on finding the differences between entrepreneurs and non-entrepreneurs. Previous studies have indicated some results of this subject but they have mostly ignored the personality aspect. In this study, the role of the environment has not been forgotten but we focus on the association between entrepreneurial identity and personality. The main aspect is to study the appearing of entrepreneurship among business students and the influence of the personality on the entrepreneurial identity.

The definition of entrepreneurship often includes the idea of new venture or enterprise creation. It is also well established that an entrepreneur as an individual differs from other people somehow. For instance, Gartner [2] describes the creation of new ventures as an interaction of several factors: personal characteristics of the entrepreneur (individual), competitive entry strategies (organization), push and pull factors (environment) and the action the entrepreneur takes (process). Schumpeter [16] also indicated that becoming an entrepreneur requires tendencies that are unique. McClelland [7] suggested that, for example, a high need of achievement, risk-taking ability, preferences for challenge, acceptance of personal responsibility and innovativeness are the characteristics of an entrepreneur. Other traits that are found to describe entrepreneurs are for instance tolerance of ambiguity and internal focus of control [1]. One of the attempts to create an entrepreneur typology was Smith's [17] theory in which he separated entrepreneurs from each other based on differences in job descriptions and characters. Smith's categories were craftsmen and opportunistic entrepreneurs. Stanworth and Curran [18] further developed the rough typology of Smith and started to call their types identities. Types of entrepreneur differ also in strategic-level goal setting [14].

The majority of the studies dealing with entrepreneurship and personality have focused on finding one description of entrepreneurs, or characteristics, which are typical of entrepreneurs. However, these studies have mainly ignored the fact that the entrepreneurs of different fields, or the different forms of entrepreneurship, might be connected with different characteristics or traits. In other words, there might be, not only one ”true” personality of entrepreneur, but also many personalities, which might favor different forms of entrepreneurship. Also the entrepreneurs' for example, orientation, to networking [15] or internalization [13] differ from each other depending on personality type. An enterprise can actually take multiple forms requiring more or less of training and various skills, like those of an expert entrepreneur, farmer entrepreneur, entrepreneur in a co-operative movement, scientist entrepreneur, venture capitalist, franchising entrepreneur, partner entrepreneur, businessman, shopkeeper, intrapreneur etc. – there is a good number of alternatives. It is not necessary for an entrepreneur or the founder of an enterprise to have all skills, since it is possible to outsource sub-functions, to purchase from a network or from a joint venture, subcontract etc. 'In a very basic form all you need is a mobile phone and good organizing skills.' It is very important to correct misunderstandings particularly in the case of youngsters. Practical training and apprenticeship training could be used with other general education to correct views. [11] It can be concluded that the personality structure of entrepreneurs differs from general population [13,15] but also entrepreneurs differ from each other and different personality types favor different entrepreneurial identities.

People who gained an academic degree can naturally work as entrepreneurs in different sectors just like other citizens. It is appropriate, however, to activate the entrepreneurial intentions of those with higher education through special actions. It is reasonable to identify those industrial sectors, entrepreneurship identities and enterprise forms (e.g. network and virtual enterprises and joint ventures), where the threshold is lowest for academic people to start up a business. Developing academic entrepreneurship is naturally a complex problem relating for example to selection, curriculum, practical training and general cultural values (e.g., many parents generally guide their children to make a choice of a secure career in the public sector). Integration of intrapreneurship, creativity, innovativeness and new business development into studies to a larger extent provides a stronger basis for entrepreneurial know-how. Furthermore, it may be mentioned, also by combining the implementation of national and regional development projects more concretely with the research and teaching activities of universities, it is possible to lower the threshold of university graduates to become entrepreneurs. Arrangements like science parks with their incubation centers and research assignments (traditional as well as action-research type of projects) serve well this purpose of objectifying needed business know-how. [11]

Personality Types

There are several ways to conceptualize and assess personality. In this study, the Myers-Briggs Type Indicator (MBTI) was used. It is based on Carl Jung's theory of psychological types and it reports personality preferences on four scales: Jungian Extraversion – Introversion, Sensing – iNtuition, Thinking – Feeling, and the Judging – Perceiving preference added by Briggs and Myers. According to Myers [10] *'the MBTI is primarily concerned with the valuable differences in people that result from where they like to focus their attention, the way they like to take information, the way they like to decide, and the way they like to adopt'.* Usually one pole dominates over another. The eight preferences are identified in sixteen types, each representing a certain preference order [9]. Briefly illustrated the preferences or dimensions are [10]:

Extraversion (E)	Interested in people and things in the world around them.
Introversion (I)	Interested in the ideas in their minds that explain the world.
Sensing (S)	Interested in what is real and can be seen, heard and touched.
Intuition (N)	Interested in what can be imagined and seen with 'the mind's eye'.
Thinking (T)	Interested in what is logical and works by cause and effect.
Feeling (F)	Interested in knowing what is important and valuable.
Judging (J)	Interested in acting by organizing, planning, deciding.
Perceiving (P)	Interested in acting by watching, trying out, adapting.

As stated by Myers & McCaulley [9], *"according to theory, each of the 16 types results from a preference for one pole of each of the four preferences over the opposite pole. A preference of any dimension is designed to be psychometrically independent of the preferences of the other three dichotomies, so that the preferences on the four dichotomies yield sixteen possible combinations called types, denoted by the four letters identifying the poles preferred (e.g., ESTJ, INFP). The theory postulates specific dynamic relationships between the preferences. For each type, one process is the leading or dominant process and a second process serves as an auxiliary. Each type has its own pattern of dominant and auxiliary processes and the attitudes (E or I) in which these are habitually used. Determining these dynamic relationships is enabled by the J-P dichotomy of the MBTI. The characteristics of each type follow from the dynamic interplay of these processes and attitudes"*.

In order to interpret the association between type and entrepreneurial identities, the types are next briefly illustrated |9].

ISTJ	Quiet and serious. Succeed through concentration and thoroughness. Practical, orderly, matter-of-fact, logical, realistic, and dependable. See to it that everything is well organized. Take responsibility. Make up their own minds as to what should be accomplished and work toward it steadily, regardless of protests or distractions.
ISFJ	Quiet, friendly, responsible, and conscientious. Work devotedly to meet their obligations. Lend stability to any project or group. Thorough, painstaking, accurate. Their interests are usually not technical. Can be patient with necessary details. Loyal, considerate, perceptive, concerned with how other people feel.
INFJ	Succeed by perseverance, originality, and desire to do whatever is needed or wanted. Put their best efforts into their work. Quietly forceful, conscientious, concerned for others. Respected for their firm principles. Likely to be honored and followed for their clear visions as to how best to serve the common good.
INTJ	Have original minds and great drive for their own ideas and purposes. Have long-range vision and quickly find meaningful patterns in external events. In fields that appeal to them, they have a fine power to organize a job and carry it through. Skeptical, critical, independent, determined. Have high standards of competence and performance.

ISTP Cool onlookers, quiet, reserved, observing and analyzing life with detached curiosity and unexpected flashes of original humor. Usually interested in cause and effect, how and why mechanical things work, and in organizing facts using logical principles. Excel at getting to the core of a practical problem and finding the solution.

ISFP Retiring, quietly friendly, sensitive, kind, modest about their abilities. Shun disagreements, do not force their opinions or values on others. Usually do not care to lead but are often loyal followers. Often relaxed about getting things done because they enjoy the present moment and do not want to spoil it by undue haste or exertion.

INFP Quiet observers, idealistic, loyal. Important that outer life be congruent with inner values. Curious, quick to see possibilities, often serve as catalysts to implement ideas. Adaptable, flexible and accepting unless a value is threatened. Want to understand people and ways of fulfilling human potential. Little concern with possessions or surroundings.

INTP Quiet and reserved. Especially enjoy theoretical or scientific pursuits. Like solving problems with logic and analysis. Interested mainly in ideas, with little liking for parties or small talk. Tend to have sharply defined interests. Need careers where some strong interest can be used and useful.

ESTP Good at on-the-spot problem solving. Like action, enjoy whatever comes along. Tend to like mechanical things and sports, with friends on the side. Adaptable, tolerant, pragmatic; focused on getting results. Dislike long explanations. Are best with real things that can be worked, handled, taken apart, or put together.

ESFP Outgoing, accepting, friendly, enjoy everything and make things more fun for others by their enjoyment. Like action and making things happen. Know what's going on and join in eagerly. Find remembering facts easier than mastering theories. Are best in situations that need sound common sense and practical ability with people.

ENFP Warmly enthusiastic, high-spirited, ingenious, imaginative. Able to do almost anything that interests them. Quick with a solution to any difficulty and ready to help anyone with a problem. Often rely on their ability to improvise instead of preparing in advance. Can usually find compelling reasons for whatever they want.

ENTP Quick, ingenious, good at many things. Stimulating company, alert and outspoken. May argue for fun on either side of a question. Resourceful in solving new and challenging problems, but may neglect routine assignments. Apt to turn to one new interest after another. Skillful in finding logical reasons for what they want.

ESTJ Practical, realistic, matter-of-fact, with a natural head for business or mechanics. Not interested in abstract theories, want learning to have direct and immediate application. Like to organize and run activities. Often make good administrators; are decisive, quickly move to implement decisions; take care of routine details.

ESFJ Warm-hearted, talkative, popular, conscientious, born co-operators, active committee members. Need harmony and may be good at creating it. Always doing something nice for someone. Work best with encouragement and praise. Main interest is in things that directly and visibly affect people's lives.

ENFJ Responsive and responsible. Feel real concern for what others think or want, and try to handle things with due regard for the other's feelings. Can present a proposal or lead a group discussion with ease and tact. Sociable, popular, sympathetic. Responsive to praise and criticism. Like to facilitate others and enable people to achieve their potential.

ENTJ Frank, decisive, leaders in activities. Develop and implement comprehensive systems to solve organizational problems. Good at anything that requires reasoning and intelligent talk, such as public speaking. Are usually well informed and enjoy adding to their fund of knowledge.

In addition to the types, the dimensions (E, I, S, N, T, F, J, P) illustrated above as well as the pairs (EN, NT, ST, etc.) of the personality in relation to entrepreneurial identities will be analyzed.

Method

The sample consisted of 283 business students, 144 males (50,9 %) and 139 females (49,1 %). Most of the respondents were ESTJs (20,9 %), ENTJs (13,1 %), ISTJs (9,9 %) or ESFJs (9,9 %) by their personality types. The most rare types in the sample were INTJs (1,4 %), ISTPs (1,4 %) and INFJs (1,8 %). Respondents preferred more Extraversion (74,9 %) than Introversion (25,1 %), more Sensing (55,1 %) than Intuition (44,9 %), more Thinking (61,5 %) than Feeling (38,5 %) and more Judging (68,6 %) than Perceiving (31,5 %). The distribution of personality types and preferences in the sample is illustrated in Table 1.

Table 1: THE DISTRIBUTION OF PERSONALITY TYPES AND PREFERENCES IN THE SAMPLE.

whole data

N = 283

ISTJ N = 28 % = 9.89 nnnnnnnnnn	**ISFJ** N = 9 % = 3.18 nnn	**INFJ** N = 5 % = 1.77 nn	**INTJ** N = 4 % = 1.41 n
ISTP N = 4 % = 1.41 n	**ISFP** N = 7 % = 2.47 nn	**INFP** N = 7 % = 2.47 nn	**INTP** N = 7 % = 2.47 nn
ESTP N = 11 % = 3.89 nnnn	**ESFP** N = 10 % = 3.53 nnnn	**ENFP** N = 19 % = 6.71 nnnnnnn	**ENTP** N = 24 % = 8.48 nnnnnnnn
ESTJ N = 59 % = 20.85 nnnnnnnnnn nnnnnnnnnn n	**ESFJ** N = 28 % = 9.89 nnnnnnnnnn	**ENFJ** N = 24 % = 8.48 nnnnnnnn	**ENTJ** N = 37 % = 13.07 nnnnnnnnnn nnn

	N	%
E	212	74.91
I	71	25.09
S	156	55.12
N	127	44.88
T	174	61.48
F	109	38.52
J	194	68.55
P	89	31.45
IJ	46	16.25
IP	25	8.83
EP	64	22.61
EJ	148	52.30
ST	102	36.04
SF	54	19.08
NF	55	19.43
NT	72	25.44
SJ	124	43.82
SP	32	11.31
NP	57	20.14
NJ	70	24.73
TJ	128	45.23
TP	46	16.25
FP	43	15.19
FJ	66	23.32
IN	23	8.13
EN	104	36.75
IS	48	16.96
ES	108	38.16
Sdom	58	20.49
Ndom	52	18.37
Tdom	107	37.81
Fdom	66	23.32

Note: n = 1% of sample. Print date: 5.9.2003

Procedure

A Finnish research version of Myers-Briggs Type Indicator (Form F) was used to assess personality type, and completing it was voluntary. The Selection Ratio Type Table (SRTT) was used to compare the distribution of types in certain entrepreneurial identity groups. SRTT was devised by Isabel Myers as a way of displaying the distribution of types within a sample and for comparing different samples. It makes either chi-square or Fisher's test depending on the number in each cell. If the Index (I) is greater than 1 the proportion in the sample is smaller than the proportion in the base. [8]

To clarify the entrepreneurial identity of business students, they were asked to respond to the questionnaire of entrepreneurial potential. They were supposed to think of themselves as entrepreneurs and answer how they saw themselves as potential entrepreneurs. Answers were given on the Likert scale (strongly disagree, slightly disagree, not disagree/agree, slightly agree, strongly agree). Respondents evaluated themselves as 19 different kinds of entrepreneur types or identities as listed below. Respondents who evaluated themselves as being most (over the mean) of each type of entrepreneur were transferred to the SRTT-table. The 19 different kinds of entrepreneur types or identities to be chosen are:

?? Agent/representative (Represent and sell products to customers against a sales commission),
?? Businessman (A work based business and scenting different transactions),
?? Businessman in team (Works in a team of 1 to 3 other entrepreneurs in a shared enterprise),
?? Co-operative entrepreneur (Sharing co-operative),
?? Franchising entrepreneur (Enterprising based on a franchising contract),
?? Farmer/forest entrepreneur (An enterprise based on running one's own farm or forestry),
?? Handicraft entrepreneur (A business based on the production or selling using one's own handicraft skills),
?? Innovator (An enterprising based on different new technical innovation produced by the entrepreneur),
?? Manager (Managing one's own company employing several people),
?? Net marketer (Sells products via or through acquaintance),
?? Part-time entrepreneur (Carrying on business in addition to paid work),
?? Restaurant entrepreneur (Running food, dancing or other restaurant),
?? Scientist (Commercializing one's learning and one's own developed research knowledge),
?? Shopkeeper (Keeping a relatively small shop (specialist shop, retail store, grill etc.)),
?? Social services provider (Taking care of old people, the sick, handicaps, households),
?? Sole proprietor (A person practicing a profession, e.g., bookkeeper, physician, masseur),
?? Subcontractor (Subcontracting know-how or production capacity for bigger companies),
?? Trainer/consultant (Selling expertise acquired by education and experience), and
?? Transport/machine contractor (Running business using one's own transport, excavator equipment).

Results

In Table 2, the 19 possible entrepreneurial types indicating the entrepreneurial identities are listed in the order ranked by the observations.

Table 2: ENTREPRENEUR TYPES AND MEANS OF EACH (ranging from 1 to 5; 1= not interested, 5= very interested)

1. Businessman in team	3,83	11. Shopkeeper	2,36
2. Trainer/consultant	3,81	12. Scientist	2,35
3. Manager	3,56	13. Co-operative	2,13
4. Businessman	3,48	14. Handicraft	2,05
5. Part-time	3,16	15. Franchising	1,99
6. Subcontractor	3,05	16. Social services provider	1,88
7. Sole proprietor	2,99	17. Net marketer	1,57
8. Innovator	2,43	18. Farmer/forest	1,52
9. Agent/representative	2,41	19. Transport/machine	1,40
10. Restaurant	2,39		

The top four consist of team entrepreneur, trainer/consultant entrepreneur, manager entrepreneur and businessman entrepreneur. The four top ranked by population in general, in Finland, were team entrepreneur, handicraft entrepreneur, sole proprietor, part-time entrepreneur [5,6]. That is, the business students naturally favor more business-minded identities but it must be kept in mind that, as can be seen, there is a clear association between personality type and entrepreneurial identity favored. Students' personality distribution is more 'managerial' emphasized than the personality distribution of the population in general.

Next, the statistically significant or else strong relationships between personality and entrepreneurial identities will be briefly reported in the order presented in in Appendix 1,2 and 3. More specific results and the level of significances can be seen in the Appendixes. It may be considered that a clear deviation of Index (I) from 1 refers to a tendency of favor or disfavor in spite of the missing statistical significance.

Of all the sixteen personality types, ESTJs (Extravert-Sensing-Thinking-Judging), one of the most common types, evaluated themselves as having most **businessman identity** whereas ISTJs (Introvert-Sensing-Thinking-Judging), another of the most common types, felt themselves having least of this identity. Also ISTPs (Introvert-Sensing-Thinking-Perceiving) and ENTJs (Extravert-iNtuitive-Thinking-Judging) tended to identify themselves with businessman entrepreneurs. Those who felt being most inclined to businessman identity were rather Extraverts than Introverts. The preference combination EJ and T-dominance (types which have Thinking as their dominant preference) were also over-represented, while combinations IJ, SJ and IS as well as S-dominance were under-represented.

ENFPs (Extravert-iNtuitive-Feeling-Perceiving) were the most willing to evaluate themselves as innovator entrepreneurs and INTJs (Introvert-iNtuitive-Thinking-Judging), ISTPs (Introvert-Sensing-Thinking-Perceiving) and ENTPs (Extravert-iNtuitive-Thinking-Perceiving) seemed also to favor this identity slightly. ISFJs (Introvert-Sensing-Feeling-judging) tend to have the least of **innovator entrepreneur identity**. On the preference level, innovator entrepreneurs seem to be more likely iNtuitive, especially NP and EN, than Sensing, and especially SJ-types. They also tend to prefer Perceiving style rather than Judging style. N-dominance was over-represented while S-dominance was under-represented.

ESTJs were the most willing types to describe themselves as **manager entrepreneurs**, whereas ISTJs and ISFJs of all sixteen types saw themselves being least prone to this entrepreneur identity. ISTPs, INTPs (Introvert-iNtuitive-Thinking-Perceiving), ESTPs (Extravert-Sensing-Thinking-Perceiving) and ENTJs tended also favor this kind of entrepreneurship. Manager entrepreneurs tend to be more Extraverts than Introverts, and more Thinking than Feeling types. The preference pair EJ as well as T-dominance was over-represented while IJs, SFs and ISs as well as S-dominance were under-represented.

When considering **scientist entrepreneur identity**, ENTPs were over-represented. ENFPs and INTJs tended also to favor this kind of entrepreneurship. INFJs (Introvert-iNtuitive-Feeling-Judging) and ISTPs tended to be the types who were the least prone to this identity. Scientist entrepreneurs seem to be more Intuitive than Sensing, and more Perceiving than Judging types, and there were especially many EPs and NPs as well as types which have iNtuition as their dominant preference. STs were under-represented.

ESTPs were the types who evaluated themselves as being least prone to **sole proprietor** entrepreneur identity while INTJs tended to have most of this identity. Sole proprietors are more likely Introverts than Extraverts and especially the EP-preference pair was rare among them.

ENTJs saw themselves as most likely to be **businessman in the team** while ISTJs and ENTPs were under-represented in this category. Potential team entrepreneurs prefer more Extraversion than Introversion. And especially EJs and T-dominated types were most interested in this kind of entrepreneurship. IJs, NPs, TPs and N-dominated types did not favor team entrepreneurship.

Types, which favored most **part-time entrepreneurship,** were ESTPs while INFPs (Introvert-iNtuitive-Feeling-Perceiving) and INFJs showed the least tendency towards this kind of solution. Part-time entrepreneurs were more likely Thinking- than Feeling-types and the number of NFs and FJs was particularly small. T-dominance was over-represented while F-dominance was underrepresented.

There were no statistically significant results when investigating the personality of potential **subcontractor entrepreneurs**, but most tendency towards this kind of entrepreneurship had INFJs and INTJs, while ENFPs were least interested in subcontractor entrepreneurship.

Franchising entrepreneurship seems to interest most ESFJs (Extravert-Sensing-Feeling-Judging) and least INTJs and ISFPs (Introvert-Sensing-Feeling-Perceiving). Particularly Feeling-types favor this style while Thinking-types do not. The preference pairs SF and FJ as well as F-dominance were over-represented while combinations NT and TJ were under-represented.

INFJs and ISFPs of all types, and especially FJs and F-dominated types tended to favor most **co-operative entrepreneurship**, while this kind of entrepreneurship did not appeal to ENTPs or ESTPs, or generally EPs.

Any significant results among potential **handicraft entrepreneurs** was not found but it seems that INTJs, ISTPs, ISFPs and INTPs, and Introverts in their entirety, tended to regard themselves as being handicraft entrepreneurs. EPs, NPs, TPs and N-dominated types do not seem to be very suitable as handicraft entrepreneurs.

The career of **trainer or consultant entrepreneur** seems to appeal most to INTPs, ENFPs, ENTPs and ENTJs, whereas ISTJs and ESFPs did not see themselves as potential trainer or consultant entrepreneurs. Altogether, this kind of entrepreneurship was more favored by Extraverts than Introverts and Intuitive-types more than Sensing-types. Especially NTs and T-dominated types showed interest in this kind of entrepreneurship, while IJs, ISs or S-dominated types did not seem to be very potential trainer or consultant entrepreneurs.

Shopkeeper entrepreneurship did not interest particularly any specific type, but INFJs showed most, and ISTJs as well as INFPs showed least tendency towards this kind of entrepreneurship. Feeling types might be a little more inclined to be shopkeepers than Thinking types.

ESFJs and ENFJs (Extravert-iNtuitive-Feeling-Judging) were the types, which showed most interest in the career of **agent or representative entrepreneur**. In the preference level, Feeling-types, EJs, NJs, FJs and F-dominance were over-represented. This kind of entrepreneurship did not appeal to ISTJs or Thinking-types, and Introverts did neither see themselves as potential agents or representatives.

Most potential **restaurant entrepreneurs** seem to be ISTPs, and to some extent INFJs, too, whereas ISTJs do not favor this kind of entrepreneurship. Feeling-types and especially NFs could consider themselves as restaurant entrepreneurs while Thinking-types and TJs were under-represented.

Conclusions

The purpose of this study was to find out if there are connections between personality and entrepreneur identities of business students. Furthermore we were interested in what kind of personalities tend to have potential to certain entrepreneur careers. The results indicate that certain personalities have a tendency to favor some entrepreneurial identities more often than others.

The personalities who were potential entrepreneurs in different fields according to the entrepreneurial identities matched well with the theory and descriptions of the personality types and preferences. For example, ESTJs are known as manager types, due to their logic, analytic thinking, objectivity and abilities to organize. They are practical, realistic and matter-of-fact personalities who act systematically and pragmatically. Therefore, it was not surprising that ESTJs favored businessman identity and manager entrepreneur identity. ISTJs, on the other hand, did see themselves neither as potential businessman or manager entrepreneurs nor as team entrepreneurs, trainer/consultant, shopkeepers or restaurant entrepreneurs. ISTJs were not favoring any of the entrepreneur identities studied but they were the least favoring several identities. Therefore it could be interpreted that ISTJs are not very potential entrepreneurs in any fields. It may be noted that also other 'typical' manager types, ESTJs and ENTJs, were not very strongly associated with any of the entrepreneurial identities, in spite of some significant results.

ENFPs described as *"curious, creative, imaginative innovators, initiating projects and directing great energy into getting them under way*" [9:79] as well as ENTPs, NPs, and Ns seem to favor identities demanding intuition, creativity and flexibility as innovators, inventors and trainers/consultants. Feeling types (Fs) tend to favor identities minimizing risk, e.g. franchising, agent or representative, co-operative entrepreneurship, offering small-scale enterprising in good company, e.g. restaurants, shop keeping. Introverts (Is) favor, according to a definition, identities that allow working alone or in small circle, e.g. handicraft entrepreneurs, sole proprietors.

In general, there are types who are not especially interested in any entrepreneurial identity, e.g. ISTJ, ISFJ, INFJ, and INFP. Further, there are types who can imagine themselves in one certain specific role, e.g. ISFP as co-operative entrepreneurs. Some types, e.g. ENFP, ENTP, favored several identities in investigative, innovative or creative working environments. All in all, any of the personality types favored any or very many entrepreneurial identities. That is, different entrepreneurial identities are very much associated with personality dimensions and types. Thus, as career orientation in general [3,4,12], personality is an important predictor of a proper entrepreneurial identity. It must be noted, however, that the associations between personality types and entrepreneurial identities reported here do not mean that some types could not act or succeed as entrepreneurs. In spite of that, this knowledge should be used in vocational guidance and entrepreneurial training. Additionally, this knowledge could be used to lessen those fears and obstacles [5,6] found by potential entrepreneurs. Referring to the many negative associations between types and entrepreneurial identities, the assumption that also business students are not very entrepreneurial-minded was supported. That is why it is very important to obtain knowledge of the possibly favored identities as well as fears of and obstacles to entrepreneurship.

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The Impact of Institutional and Environmental Conditions on Entrepreneurial Activity

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Abstract

Adverse environmental factors generally have a negative impact on entrepreneurial activity in a given country or a large region within a country. Environmental conditions in this paper refer not only to the physical or infra-structural attributes of a territory such as roads, ports, rail services, airports and access to broad band connection, but it also includes human capital, political and economic institutions, such as government bureaucracies that issue business licenses and private and public banks that offer capital for investment purposes. Through a case study of small and mediums sized firms in Kerala state, a region within South India, which historically has shown an unusually strong record on social development, this study identifies the most important barriers to entrepreneurship and economic growth in Kerala. In doing so, this research also reveals what other would-be entrepreneurs could learn from successful Kerala firms to survive in this otherwise hostile business environment.

Introduction

How are new entrepreneurial opportunities to be recognized by would be entrepreneurs? Is there a standard generic checklist or an off-the-shelf product available on the market to advice nascent entrepreneurs of things to avoid prior to setting up a business? Is a stable business environment imperative in order for a new venture creation to be successful? A straightforward answer to the latter two questions would be "no". Carter, Gartner (1996) and Reynolds (1997) maintain that nascent entrepreneurs are not homogenous, and that usually those who eventually end up starting up a business, as opposed to those who give up after weighing out the risks, take up a lot of initiatives, such as gathering the necessary resources and information to ensure that their business plan turns out to be feasible in practice. One of the principle aims of this case study based research work on the South Indian State of Kerala is to highlight that new innovation and business opportunities may often arise from the most adverse environmental conditions. If one were to point to recent technological innovations, the introduction into the market of fuel efficiency cars, for example, may be seen as creativity driven largely by environmental adversity. The described market demand was motivated by the petroleum crisis of 1973. During the oil shocks, the sudden shortage of supply and high cost of fuel meant that viable revenue generating alternatives had to be sought by the automobile industry in order to avoid bankruptcy. In the same light, it is proposed in this study that truly innovative entrepreneurs are able to identify strong business opportunities sometimes in unusually hostile environments. Carrying out a business venture under unfavourable environmental conditions generally mean that the markets are unlikely to be fully competitive, and therefore the opportunities to expand profit margins are likely to be greater to compensate for the proportionately high risk. Hence, instead of being faced with the problem of "crowding out", new venture creation in a hostile business environment (characterised by varying obstacles such poor infrastructure, high cost of land, labour volatility and energy shortages), allows entrepreneurs to identify new business opportunities and to develop effective strategies to extract higher returns on their investment. Though there is no commonly accepted definition of entrepreneurship, most scholars on entrepreneurship concur that entrepreneurs tend to be risk un-averse. However, it would not only be reckless, but it would also be unequivocally erroneous to infer from this research that all hostile business settings invariably provide positive opportunities for entrepreneurs. The main aim of the study is instead to draw attention to entrepreneurial processes and strategies required in order to succeed in otherwise difficult environmental conditions.

Through evaluating the economic development and constrained entrepreneurial initiatives in Kerala, India, this study focuses on some of the adaptive strategies that successful entrepreneurs have relied upon in a specific hostile business setting. The implication of the research is that certain generalizations can be made about how adaptation by entrepreneurs to a hostile business environment is positively related to entrepreneurial outcomes.

The Relevance of Kerala as Case Study of Entrepreneurship

Throughout the past three decades, the development efforts pursued by subsequent governments in the South Indian State of Kerala, have been closely followed with a great deal of interest by experts in the field of economics, international development and social policy from within as well as outside of India. Curiously, similar interest has not been shown on the region by specialists in business policy or strategy. Intrigue with the development experience in Kerala has been sparked largely as a result of the relatively high standard of living that has been achieved in this industrially under-developed region (approximately the size of Spain in population terms) with a low per capita income level of $182 in 1986. If one were for example, to rely on proxy indicators such as the Sen Index or Morris' physical quality of life index (PQLI) to measure standard of living, Kerala's performance level would not only be seen as better than many developing countries, including China. Morris' PQLI include arguably the four most important characteristics of social development, life expectancy, infant mortality, birth rates and adult literacy rates. What is astonishing about Kerala's accomplishment is that if it were to be seen as a separate nation state, it would rank as the ninth poorest in the world. Nevertheless, Kerala's social achievements could be compared with most developed countries with income levels that are ten to twenty times higher. The prospects for survival for both men and women in Kerala are greater than for Blacks in the United States. The female literacy rates in Kerala are also higher than those in every province in China. Kerala has a population of 29 million (1991), a total area of 38,863 sq kilometres and it accounts for 3.43 per cent of the population of India. What is particularly noteworthy is that the social benefits in Kerala are distributed on a fairly equal basis, irrespective of gender, caste and across rural and urban areas. However, in terms of conventional performance indicators such as GDP per capita, State domestic Product (SDP) and growth rates within various productive sectors of the economy, Kerala falls far below the national average. Thus, the development approach pursued in Kerala is viewed as a paradox by many observers because a relatively high social standard of living has been achieved (at low per capita SDP), which is often associated with high income regions. Another reason that many observers perceive the development process in Kerala as a paradox stems from the presence of a high saving ratio (which could potentially serve as invertible resources), rich human capital resource endowment and high ranking per capita consumption expenditure. All of these ingredients generally tend to translate into strong possibilities for the establishment of a vibrant entrepreneurial class and the required market as well as for the promotion of advanced industrial activities. However, the performance of productive sectors, both within agriculture as well as in manufacturing remain relatively poor.

TABLE 1. REAL PER CAPITA INCOME OF THE FOURTEEN LARGEST INDIAN STATES (RS 1980-1 PRICES).

	Per capita income						**Growth rate (%)**		
	1980-1	**Rank**	**1990-1**	**Rank**	**1996-7**	**Rank**	**1980-1 1990-1**	**1990-1 1996-7**	**1991-2 1996-7**
High-income states	*2385*		*3269*		*4377*		*3.2*	*6.1*	*3.9*
Punjab	3020	1	4163	1	4935	2	3.3	2.8	3.1
Maharashtra	2671	2	3826	3	5358	1	3.7	7.4	4.4
Haryana	2647	3	3864	2	4392	3	3.9	2.6	3.2
Gujarat	2200	4	3047	4	4221	4	3.3	8.6	4.2
West Bengal	1912	5	2349	6	3146	6	2.1	4.9	3.2
Middle-income states	*1607*		*2159*		*2676*		*3.0*	*4.2*	*3.2*
Karnataka	1690	6	2295	7	2988	7	3.1	3.4	3.6
Kerala	**1690**	**7**	**2106**	**8**	**2705**	**8**	**2.2**	**4.9**	**3.0**
Tamil Nadu	1677	8	2514	5	3297	5	4.1	5.2	4.3
Andhra Pradesh	1543	9	1997	10	2432	10	2.6	3.8	2.9
Madhya Pradesh	1508	10	1951	11	2205	11	2.6	4.1	2.4
Low-income states	*1308*		*1725*		*1840*		*2.8*	*1.8*	*2.1*
Uttar Pradesh	1418	11	1842	12	1997	12	2.6	1.8	2.2
Orissa	1415	12	1555	13	1933	13	0.9	1.5	1.6
Rajasthan	1373	13	2170	9	2533	9	4.7	3.9	4.3
Bihar	1062	14	1374	14	1245	14	2.6	-0.7	1
Average of 14 states	*1715*		*2310*		*2842*		*3*	*4.4*	*3.2*

In recent years, there have been a number of plausible theories put forward to explain the causal factors to low entrepreneurial activity and to poor performance within the productive sectors. These range from such issues as, centre/state conflict and unequal federal financial allocation, which is believed to have forced the state government of Kerala to spread its planned expenditures over many unplanned areas in order to sustain, let alone improve human development initiatives (e.g. the level of public services in health, education and food rationing policies) that it had already put into place. The end result is that state finance for productive sectors has been severely curtailed and public services have deteriorated considerably. This explanation has not gained much ground amongst experts on the region, though it remains an issue of serious concern. Energy deficiency within the state has also been identified as a highly significant reason for the poor performance within the productive sectors. Kerala relies almost entirely on hydro-electric power for its energy requirements. A recent study has shown that the years of particularly poor growth rates have coincided with years of bad monsoons. Nonetheless, this explanation begs the question of whether all other energy deficient states in India have performed equally as bad as Kerala during years of bad monsoons. If the answer is no, then it would raise doubts about this explanation as one of the main causes for low growth. Another competing explanation to the poor performance of the economy is high price of land and the theory of labour unrest. According to the labour unrest argument, labour is seen as much more volatile and expensive in Kerala than in any other state in India. It is this last point which will be the focal point of this paper. All these mentioned factors may have had or continue to have an impact on Kerala's economy, but what is unclear is the direct causal relationship between these variables and the near obsolescence of entrepreneurship and poor performance of the productive sectors. Thus far, there have been no successful attempts to quantify the impact of these factors on the state's poor performance.

There are a number of key historical processes that have enabled Kerala to achieve positive outcomes within the social sphere. Apart from a strong tradition in social policies which dates back to the late 19th century, mass mobilization and direct public action have been the two most significant factors to influence human development outcomes since the creation of the state in 1957. Some critics have argued that the mentioned social achievements are unsustainable over the long term, given the heavy indebtedness of the state and the general poor performance of the economy.

One of the instrumental objectives of this research study is therefore to empirically investigate the underlying causes to low growth in Kerala. More specifically, it sets out to draw attention to key factors within the region which deter entrepreneurial activity amongst a highly educated, skilled and able working population. A second related goal of the research is to reveal what successful firms and entrepreneurs have done (strategies) in order to succeed in a considerably hostile business environment.

Proposition

The main hypothesis put forward in this study suggests that irrespective of a strong record on human capital formation, the business environment in Kerala is considerably more hostile than other regions within as well as outside the Indian sub-continent. The most salient environmental conditions which restrict productivity growth and entrepreneurial activity in the state are thought be, labour volatility (strikes and restrictive labour practices), high wages, political party intervention, poor industrial development policy at a state level (i.e. issuing of licenses, lack of government incentives such as tax subsidies, access to investment credit), high energy tariffs, poor infrastructure and high cost of land. How can these assumptions be tested empirically?

Research Methodology

Entrepreneurial activity will be measured in this study by examining the pattern, and motives behind new investments made in neighbouring regions by leading Kerala industrialists. Organizational behaviour (i.e. the firm, in accordance with Herbert Simon) Institutional, transactions costs (in the Coasian tradition) and evolutionary economics offer theoretical insights for examining the question of why some firms and entrepreneurs have failed disastrously in Kerala whilst others have been highly successful, inspite of undertaking entrepreneurial initiatives within the same commercial environment.

Data on the industrial sector in other Indian States and on human development indicators have been gathered and analyzed in this study in order to make inter-state comparisons of wages, growth rates in manufacturing and on living standards. The main sources of secondary data relied upon in this study, which include, wage rates and labour productivity in the factory sector and small scale industries (SSI) are published in the Annual Survey of Industries (ASI). Estimates of State Domestic Product 1960-61 to 1982-83 (SDP) are published in the Central Statistical Organization (CSO). The key approach, however, to identify a possible causal link between the points mentioned above and the near obsolescence of dynamic entrepreneurial activity in the state has been through carrying out interviews with 50 of the state's leading entrepreneurs. The interviews were carried out personally during October 2000 to March 2001, and in most cases involved visiting production facilities in Kerala as well as in Tamil Nadu State and meeting with owners of firms, members of senior level management, labour union representatives and workers. Basic statistical data and relevant information (i.e. names and contact details of CEO´s owners,) regarding the leading entrepreneurs and enterprises in Kerala were obtained from Dhanam Magazine and Business Deepika, the two leading business magazines in Kerala state. Starting in 1998, Dhanam magazine has published feature stories about the top 100 and 50 leading enterprises in the state. The main criterion used by Dhanam for selecting leading firms is on the basis of public perception and by other industrialist both from within and outside a given industrial sector.

Limitations and Strengths to the Industry Survey Method.

There are a number of restrictions associated with the questionnaire-interview approach employed in this industry survey study of Kerala firms. For example, (1) The interviewed managers may exaggerate claims about firm performance and in some cases under report labour management disputes to avoid being perceived or represented as incompetent (2); Owner/managers may conceal information about the enterprise to avoid being presented in the local media or in any formal scientific journal as a problematic firm (3); Patriotic sentiments on the part of interviewees may also get in the way of an outside researcher possibly making unfavourable reports (in the foreign press) about how companies, labour unions and governments function in the state of Kerala (4); the interviewer may be perceived as a government agent trying to extract incriminating information about dubious company accounts and therefore balance sheets and reported earnings and losses could be exaggerated or under-reported (5);. If a senior manager is being interviewed, s/he may be reluctant to disclose factual information regarding the functioning of the enterprise, out of fear that the interviewer could have been hired by the owner to test management loyalty (6). Lastly, and most importantly, the criteria relied upon by Dhanam Business Magazine to select the top 100 firms in Kerala are somewhat weak in purely empirical terms. The companies on their list for example, have not been selected on the basis of number of employees, annual turnover rate, sustained high profits over fixed costs during a period of 5 years, or company growth in terms of establishment of new subsidiaries or joint partnership with foreign multinationals. Public perception and the opinion of industry experts according sector have been the main sources used by Dhanam to select the 100 and top 50 leading firms in Kerala.

The upside to the industry survey approach employed in this study is that it enables one to gain first account information from entrepreneurs, managers, labour and syndicates themselves about actual obstacles they face on a day to day to basis. Primary level data of this type can augment and, in some cases be much more reliable than estimations of causes to low growth that could be derived from computing and analysing secondary level macro and micro data. The type of industry survey carried out this study is also much more effective than a mail-in questionnaire or telephone interview, in that it allows for physical observations to be made of firms (visits of production facilities) by the investigator.

Each personal interview lasted between 2-4 hours and involved meetings with owners, senior managers, labour union representative and workers. Though Dhanam Magazine´s selection of leading firms is not based on an empirically rigorous and testable criteria which most economists would deem necessary for a study of this type, the data they provide are nonetheless valuable given that no better alternative source of information regarding firm behaviour in the region is readily available. Therefore, the data made available by Dhanam provided a useful starting point to procure more information about the top industrialists in the state. The conclusion reached by Dhanam Magazine about leading firms and industrialists in the region, coincide for the most part with the conclusions reached in this study.

Results of the Industry Survey

Out of the 50 top enterprises in Kerala state, where interviews where carried out, 19 have relocated production facilities to neighbouring states and to other regions of the country. Out of this group of 19 firms, 14 have listed high wage costs as the main influencing factor for shifting production facilities outside of Kerala. Ten out of the mentioned 19 firms have also indicated that political party intervention through collaboration with labour syndicates as the second most important reason for relocating some of the production plants to neighbouring states. Political parties (offshoots from both the main conservative and socialist parties) are reported to intervene and often times to instigate conflicts within firms with the sole purpose of extracting rents in the form of periodic bribes and annual payment requirements. The strategy goes as follows: Competing labour unions that are formally represented at a given firm, through pressure from different political parties make demands for wage increases or for an annual bonus of 30 percent. If representatives of labour syndicates do not comply with the request of the party/ies, then mafia style revenge is sought by the political party. In other words, often times syndicates are forced into creating conflict between labour and management by competing political parties. In such scenarios, when management decline to comply to labour's request, the political party (to which each main labour union is attached to) that is able to achieve the best deal with management, by negotiating on labour's behalf and to reach a satisfactory settlement are ensured party loyalty and labour votes. In exchange for the favour, the firm owners are also then required to pay the respective political party/ies for striking an acceptable deal. Nine out of the 50 firms also list poor government incentives and poor infrastructure as the third most important reason for relocating to production facilities to other regions. For one firm, Popy Umbrella, lack of government incentives was the main reason given for shifting production facilities to Rajasthan. The distribution of employment creation in other Indian states by Kerala firms and entrepreneurs is as follows in order of significance: Tamil Nadu (5130), Karnataka (1495), Andhra Pradesh (840)

Rajasthan (550) and Mumbai (120). All in all, a total of 8,135 jobs have been exported out of Kerala during the 1990's due to the problematic business environment conditions mentioned above. Also, an estimated 40,000 ancillary jobs alone have been created in Rajasthan by Popy Umbrella. Given that Kerala state has one of the highest rates of unemployment in the country when compared to other regions, particularly educated unemployment, labor loss due to hostile environmental factors should be of serious concern to policy makers.

A perhaps equally if not more alarming finding of the survey is that 23 of those firms out of the list of top 50 firms in Kerala that did not relocate production facilities to other states, indicate that labour volatility, high wages, political party intervention through collusion with labour unions, lack of an integrated industrial policy by the state and outdated labour laws (in order of significance) are the main barriers to productivity growth.

Lessons in Strategy to be Learned

The CEO of Almagam Enterprises, for example found a way to keep out labor unions altogether in the firm's Kerala operations. This is a laudable achievement, given that Amalgam has 2000 employees. How was this strategy achieved? The tactic within this firm was to provide loans to employees during periods of critical importance. Most banks were unwilling to provide loans to such a high risk group. According to the CEO of Amalgam, there are three important periods when loans are required by his workers. They are, during birth, death and during marriage. Through providing loans to his workers during this these critical periods, Amalgam's CEO is able to achieve company loyalty and in some sense a form of debt peonage. Mr. Ramesh, the owner/manager of SD pharmacy on the other hand employs a somewhat different strategy to keep troublesome labour unions out of his firm. SD pharmacy has 200 employees. Firstly, Mr. Ramesh divides his staff into units of 50 workers for the specialization of oriental medicine production. Decentralization of the workforce is carried out as a safety measure against strikes. Secondly, Mr. Ramesh only employs married men. According to him, married men are perceived as behaving more responsibly in India than single males. Thirdly, Mr. Ramesh does not employ relatives of employees, as laying them off would potentially create greater problems. Lastly and most importantly, Mr. Ramesh of SD Pharmacy provides 40 percent of his wages in kind (i.e. food and medicines). He asserts that "this way even if 60 percent of the wages are wasted by the worker on drink or other vices, the basic needs of the family are met". Though these strategies may seem rigid and draconian to some extent, they nonetheless demonstrate the necessary skills that a successful entrepreneur must possess in order to adapt to a unique and complicated business environment. An another innovative strategy that has been employed by Mr. Chitilapilly, owner/manager of Vigod electrical goods industries, perhaps the most successful entrepreneur in Kerala state, in order to avoid labour unrest and to increase productivity was to sub-contract work out to various charitable organizations. This method also meant that the size of each production unit would be significantly smaller than the large scale factory unit which was previously responsible for all production. Fortunately for Vigod, the kind of manufacturing that they specialize in does not require assembly line production. Vigod's technicians and engineers provide the necessary training to small production units. Key positions (supervisory and quality control) are occupied by Vigod staff. The remaining workers are contract labour. Vigod have 2500 employees, but only 600 are officially listed in their books. A similar decentralization strategy of outsourcing work to religious charities is employed Mr. Jacob, owner/manager of Kitex Garments, which specializes in the production of umbrellas and hand bags. Mr. Jacob's team of technicians provide the outsourced group with training and materials (sewing machines and fittings for umbrella parts) in exchange for wages. This strategy is employed to avoid labour unrest and to also increase profit margins by getting access to lower cost labour. Both Vigod and Kitex Garments have experienced severe labour unrest problems in their firms and therefore have learned to adapt and find strategies to overcome such obstacles. Both firm owners have also set up production facilities in the neighboring state of Karnataka as an insurance mechanism in case of disruption in the Kerala production plants. Other successful family run firms such as Synthite Limited provide employee incentives such as access to low interest loans for home purchasing, where such loans would not be made available to blue collar workers by public or private banks. All of these strategies may be seen as survival and adaptive strategies undertaken by entrepreneurs to survive and prosper in a hostile business environment.

Implication of Research Findings

Disentangling fact from fiction in rhetorical debates and unresolved disputes within and between various groups, as competing political parties and governmental organizations at a regional, national and international level can be formidable even under the most favourable of conditions, characterised by the prevalence of democratic political institutions and easy access for the majority of the population to uncensored information through the media (newspapers, television and radio). The truth in most such cases usually lies somewhere in between the two extreme poles and often tends to be possessed by individuals and groups from both sides of the political divide. A similar parallelism could be made when providing a causal explanation to the ongoing debate surrounding low productivity growth and limited opportunities for entrepreneurship in Kerala, an otherwise highly favourable region for economic development with a strong record on human development, political freedom, high savings rate and a highly skilled labour force. No all encompassing explanation or single entity can be isolated out as the sole cause behind low productivity growth and for the general lack of entrepreneurship spirit in the state. The complex relationship at an institutional level in Kerala's business environment between firms (entrepreneur-owner-manager), organized labour unions/workers and competing political parties at a state level have been identified in this fieldwork oriented research as one of the main undermining forces to entrepreneurial activity and productivity growth. If a general term were to be required to explain this trend, institutional failure would be the one that fits best. Through employing analogies from evolutionary biology, each of the mentioned groups in this tri-alliance can be seen as playing an integral part in putting up barriers to productivity growth and to subsequently reducing their own chance of survival and reproduction (to succeed) by not having learned to adapt to the environment in which the co-exist and operate. A brief account of the perceptions and the real existing tensions between management, labour/labour unions and political parties will serve to shed more lightly on this problem.

The Firm

The relationship between labour and management in most manufacturing (small medium and large sized) firms within Kerala is excessively hierarchical and often feudalistic in form. There is virtually no opportunity for labour to have any input about productivity decisions. Orders are generally handed down by management and they are to be unquestionably carried out by labour. The bureaucratic structure of a family run firm, private-public joint venture or fully public enterprise tends to be overly centralized and "top down" in nature. Even senior level managers or heads of different divisions within a firm are seen to be treated like glorified clerks by the owner/manager or by a CEO of a firm controlled by shareholders. The relationship between labour and the entrepreneur owner/managers of a firm can be summed up as one of "us against them" mentality.

Organized Labour

Labour unions, on their part tend to consistently be non-cooperative and non-compliant in labour management disputes, and to regard owner/managers or CEO's of shareholder firms as the enemy or exploiters. Moreover, there is a sense of disunity even amongst different labour unions within the same firm. Often times (depending on the size of the enterprise in terms of number of employees) there are up to 10 different labour unions competing for legitimacy within a firm. Only four unions are legally permitted within a firm. Labour unions can be legally kept out of production units comprised of 20 employees. The main labour unions often tend to be linked to the main political parties. This lack of coordination and cooperation between different labour syndicates impedes effective dialogue between labour and management within a firm. Workers on the other hand, tend to regard management as indifferent to their needs and therefore adopt an attitude of doing as little as possible (through restrictive labour practices) unless otherwise forced to do so through monitoring and enforcement mechanisms imposed upon them by their superiors. Ironically, workers appear oblivious to the fact that doing as little work as possible can result in their own demise (species extinction) if the company were to close down due to sustained losses over an indefinite period.

Political Parities

In the case of Kerala, the level of political party corruption is reported by leading entrepreneurs in the state to be notably higher than other regions of India. The behaviour of politicians in their relationship with firms in Kerala can be seen as misguided in terms of long-term survival. Their main goal is to extract as much rent in the form of bribes for themselves and to pass the remaining amount to the political party to which they belong. The perception of management/owners of firms by politicians is one of distrust on the one hand, and supplier of funds on the other. There is general belief amongst politicians and labour unions that firm managers or owners, if left to their own devices, would exploit labour (expose them to harsh unfair working conditions and offer very low wages). Ironically the system of checks and balances that politicians have put in place to avoid the exploitation of labour appears to achieve the exact opposite effect both for them, as well for labour. The continued abuse of management by political parties through collusion with labour unions has resulted in companies decentralizing production to avoid the presence of unions and to also relocate production facilities to neighbouring states.

As a consequence of these developments (the theoretical construct offered in evolutionary economics would suggest that), competing political parties in Kerala run the risk of not being elected or re-elected as a result of their unscrupulous conduct within firms through collaboration with organized labour. Likewise, the firm can also be seen as sacrificing its chances of increasing its market competitiveness by not adequately taking into account the significant impact which fair labour practices and the implementation of adequate rewards and incentive mechanisms in management/labour relationships can have on company profits and sustained growth. Labour unions also appear to bypass the opportunity to be represented in new and existing firms as a consequence of their opportunistic behaviour and collusion with political parties. Lastly, employees can be seen as overlooking the acute need to hold on to their jobs or for achieving promotion within the firm by demanding higher wages and bonuses without achieving corresponding results in productivity (i.e. through carrying out restrictive labour practices). In order to survive and to succeed in a such a hostile business and highly politicised climate, each of the mentioned groups would need to make appropriate compromises, coordinate better with each other, recognize the need for a collective aim and to learn to adapt and to adopt strategies that are best suited to the prevailing environmental conditions. Clearly, transforming the business environment through carrying out broad institutional reforms at a governmental (legal, bureaucratic, financial), infrastructure, firm (owner/management) and labour syndicate level would greatly contribute towards fomenting entrepreneurship and productivity growth in the region, but often times these lofty objectives remain just that and are extremely difficult to implement at a policy making level. This is not to suggest that these goals cannot be achieved, but in the meantime or interim period, alternative strategies have to be employed by Kerala's entrepreneurs to remain competitive and to achieve productivity growth and profits. In the case of many of the successful Kerala firms, the best strategy has been to relocate partly or entirely to a new environment that allows greater prospects for survival and success through increased market competitiveness and better incentives. Ten out of the top 50 firms identified by Dhanam Magazine, the leading Business Weekly in Kerala, and where interviews have been conducted as part of this research study have done precisely that. They have subsidiaries in neighbouring states and other regions in India. If a new breed of potential young entrepreneurs were to follow suit and to imitate such strategies in order set up business, then the prospect of endogenous industrial development in Kerala would not look particularly bright for the proximate future.

Conclusion

Through carrying out fieldwork based study of the causes of poor productivity growth and entrepreneurial activity in Kerala, India, this research has shown that hostile environmental conditions and institutional barriers can have a detrimental impact on macroeconomic growth. On the other hand, this research has shown that difficult environmental conditions can sometimes provide wealth generating opportunities for innovative entrepreneurs whom posses adaptive traits and are able to develop strategies to cope against harsh institutional settings. The study also shows that entrepreneurship must not be studied or assessed in isolation, in purely in an economic sense, but that the process of entrepreneurship has to be examined within the social context which determines the various types and forms of entrepreneurial outcomes.

The results of this study provide several useful insights to would be entrepreneurs in any part of the world to the importance of adaptation to the business environment, to gather the necessary information and to develop strategies not only to survive but to excel in a complex environmental setting characterised by various forms of institutional hardships (bureaucratic constraints, access to finance for investments, poor infrastructure etc..) A deep knowledge and thorough understanding by the entrepreneur of the rules of the social context in which a new business is undertaken is critical for success, particularly if the venture is to be carried out in hostile environment. This knowledge can be acquired, according to Jack and Anderson (2002) through social embeddedness, whereby the entrepreneur becomes part of the local social structure, or through entering into a partnership with an existing firm from within the chosen environment (joint venture). Resource dependence theorists such as (Pfeffer and Sanacik (1978) suggest that differentiation and diversification encourage organizational survival and growth. Adherents of this school maintain that the newly created organization or firm has to play an active role to adapt to the environment.

The strategies adopted by the successful firms in Kerala show that shifting some of the production facilities to neighbouring states has served as insurance mechanism against bribery payments by the state government of Kerala (through agitation via labour syndicates within firms). If firms are threatened with closure, then the option of shifting all of the production activities to an existing plant outside the state has served and continues to serve as a deterrent to bureaucratic interference. Moreover, it is worth noting that the nearly all of the 19 firms that have shifted some of their production facilities outside Kerala, have either opened up several new business ventures or sustained their existing enterprises in Kerala. This business practice demonstrates that Kerala is a desirable state for new venture creation and for sustaining existing ones. The relevant points to bear in mind are that if one is operating in an earthquake zone, it would be unwise to build a brick office building. It would be strategically more effective to construct a wooden edifice that can sway without crumbling down or can withstand the movements of the ground below. Likewise, if land prices are too high, the optimum business strategy would be to build upwards rather than outwards, or to set up the new venture in an area where land prices are not so prohibitive. Lastly, if labour costs are higher than market standards, to set up a new venture that is non labour intensive, to move production facilities to a low cost area, or to provide appropriate incentives to increase productivity output which correspond to higher than average wages would be the most appropriate choice. Whether a new venture creation is undertaken in a hostile climate by a nascent, novice, habitual, serial or portfolio entrepreneurs, adaptation to the environment and the adoption of strategies that coincide with the social and physical context are fundamental for survival and for entrepreneurial success. If this message has been clearly articulated through the fieldwork research on Kerala, then the modest goal of investigating entrepreneurship behaviour and processes in a specific developing country social context will have served to broaden our knowledge and understanding of the impact of environmental conditions on entrepreneurial activity.

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Sample Survey of Kerala Enterprises

Company	Description	Sector	Number of Employees	Annual Turnover (Million USD)	Initial Investment (Million USD)	Jobs created in other Indian States	Reasons for relocating	Barriers to growth
Gaanam Hotels Ltd	Hotel with 150 rooms. Sangeetha	Services	90	N/A	2.125			?? poor government support ?? too much labour volatility ?? high wages ?? political party intervention
Penthouse Aparell Ltd (part of Gaanam)	Garment factory. Founded in1997	Textiles		N/A	0.638	200 in Karnataka	?? lower labour costs ?? better financial incentives (government) ?? no labour volatility problems	
Foster Foods* (Craze Biscuits)	Produces biscuits. Founded in 1992. President's award for best performing small firm in India 2000	Food & Beverage	225	N/A	1.276			?? labour rigidity ?? unwillingness to take new responsibilities
Al Gayathri Trading Company Ltd	Tea packing and exporting	Food & Beverage	60 full time 350 contracted workers	10	N/A			
Popy Umbrella*	Umbrella manufacturers	Manufacturing			22.324	550 in Rajasthan 120 in Mumbai 40,000 anciallary jobs in Rajasthan		
SD Pharmacy	Production & Marketing of Ayurvedic medicines	Pharmaceuticals	400	1.701	N/A			

Company	Description	Sector	Number of Employees	Annual Turnover (Million USD)	Initial Investment (Million USD)	Jobs created in other Indian States	Reasons for relocating	Barriers to growth
Western India Plywoods Ltd	Plywood & hardboard	Manufacturing		11.616				Factory shut down temporarily in 1999 due to labour unrest (strikes over long term settlement disputes)
Kerala Spinners (Birla Group)	Cloth spinning company	Textiles		5.913 (Kerala) 60 All India		1,250 jobs have been created in Tamil Nadu and Karnataka due to labour unrest	High cost of labour Labour volatility High transportations costs	
Vigod Industries	Electrical goods	Manufacturing	2,500 (only 600 officially listed)			1,250 in Tamil Nadu and Karnataka	High labour costs Political party intervention Interfering labour unions	
V-Star	Ladies garments	Textiles				200 in Tamil Nadu	High labour costs Political party intervention Interfering labour unions	
Kitex Ltd*	Cloth manufacturers	Textiles	900	5.069		Opened a subsidiary in Tamil Nadu in 2000 (investment of 10 Million US$)	High labour costs Political party intervention Interfering labour unions	
Kitex Garments	Shirts, Trousers, hand bags & umbrellas	Textiles	1,200	7.603				High labour costs Political party intervention Interfering labour unions
Kitex Weaving	Cloth weaving	Textiles	300	4.224				High labour costs Political party intervention Interfering labour unions

Company	Description	Sector	Number of Employees	Annual Turnover (Million USD)	Initial Investment (Million USD)	Jobs created in other Indian States	Reasons for relocating	Barriers to growth
Anna Aluminium	Cooking vessels	Manufacturing	500	6.336				High labour costs Political party intervention Interfering labour unions
Chackson Pressure Cookers	Cooking vessels	Manufacturing	150	2.534				High labour costs Political party intervention Interfering labour unions
Sara Spices	Spice packaging	Food & Beverage	300	1.267				High labour costs Political party intervention Interfering labour unions
Jack's Metals	Metal processing	Metallurgy				400 employees in Tamil Nadu (investment 4 Million US$)	High labour costs Political party intervention Interfering labour unions	
Jacks's Weaving	Cloth weaving	Textiles		5.069		400 employees in Tamil Nadu	High labour costs Political party intervention Interfering labour unions	
Superstar Distilleries and Foods Ltd	Alcohol distillery & other beverages	Food & Beverage	120 full time 160 part time	6				Poor government support Political party intervention Interfering labour unions
Patspin India Ltd (GTN Group)	Cloth spinning	Textiles		4.224		800 employees in Tamil Nadu	high cost of labour cheaper input costs better financial incentives	

Company	Description	Sector	Number of Employees	Annual Turnover (Million USD)	Initial Investment (Million USD)	Jobs created in other Indian States	Reasons for relocating	Barriers to growth
Indian Aluminium Company Ltd (INDAL), Birla Group	Smelting metals	Metallurgy	650	22.175				Labour unrest Interfering unions Political party intervention Restrictive labour practices
Harrison Malayalam Plantations Ltd	Tea plantation & rubber	Agriculture	27,000					Outdated labour laws
Kerala Chemicals and Proteins Ltd	Gelatine production for pharmaceuticals	Chemicals	240	13.939				Restrictive labour practices Outdated labour laws
Excel Glasses (Parjit Group)	Glass bottles, chemicals & container manufacturing	Glass Manufacturing & Pharmaceuticals	650	10.560		Pharmaceutical, chemicals containers manufacturing units have been shifted to Maharashtra	High power tariffs Labour volatility High wages cost	
Parragon Footwear*	Footwear	Shoe manufacturing	1,000	42.239		500 jobs in Tamil Nadu	High cost of labour Labour unrest Poor infrastructure Interference by political parties and unions	
Eastern Group*	Curry Powder & spices	Food & Beverage		15		500 jobs in Tamil Nadu 40 Andhra Pradesh	High cost of labour Labour unrest Poor infrastructure Interference by political parties and unions	

Company	Description	Sector	Number of Employees	Annual Turnover (Million USD)	Initial Investment (Million USD)	Jobs created in other Indian States	Reasons for relocating	Barriers to growth
Premier Tyres	Tyre manufacturing	Tyre Manufacturing		27.455				Labour rigidity Unflexible labour unions Political party intervention High labour cost Low labour productivity
Colombo Umbrella	Umbrella manufacturing	Manufacturing	600	4.224				Labour unrest High labour costs Poor infrastructure High interest rates
FACT (Fertilizers and Chemicals Ltd)	Fertilizers & Chemicals	Chemicals	7,334	265.671				Inefficient labour Excessive protection of labour by the state Interfering labour unions
Travancore Cements Ltd	Cement & paint producers	Minerals & Chemicals						Closed due to: Strikes due to labour/management disputes Political party intervention Excessive interference by labour unions International competition from Gulf states Stricter pollution controls
INDSIL Electrosmelts Ltd	Smelting company	Metallurgy			7,608	300 jobs in Tamil Nadu	Labour volatility Lower labour costs Better access to raw materials	

Company	Description	Sector	Number of Employees	Annual Turnover (Million USD)	Initial Investment (Million USD)	Jobs created in other Indian States	Reasons for relocating	Barriers to growth
Precot Textiles Ltd (Precot Mills Group)	Cloth manufacturing	Textiles	800	42.265		200 jobs in Tamil Nadu 800 jobs in Andhra Pradesh	Political party intervention Labour unrest Restrictive labour practices	
Arya Vaidya Pharmacy Ltd	Herbal & traditional ayurvedic pharmaceuticals	Pharmaceuticals		3.170		280 jobs in Tamil Nadu	Poor government support High labour costs	
Elite Group (Fabrics, Distilleries and Beverages)*	Bread manufacturing	Food, beverage & textile	500	26.416		Fully automated bread making unit in Tamil Nadu (2001)	Labour unrest	
Casino Group*	Hotel & Restaurant Chain	Services						
Amalgam Enterprises (Joint venture with foreign partners)	Processing, Packaging & Export of seafood		2,000	100				No labour unions in any of the plants in Kerala, no labour problems at all
Oiga Agencies	Cooking vessels & utensils manufacturing	Manufacturing	500 (1985) 62 (2001)					High cost of land Power tariffs too high Lack of government protection in labour management disputes
Milma (Dairy Cooperative)	Dairy	Foods & Beverage	573					Labour volatility still persists Low productivity High wages

Company	Description	Sector	Number of Employees	Annual Turnover (Million USD)	Initial Investment (Million USD)	Jobs created in other Indian States	Reasons for relocating	Barriers to growth
Indus Motor Company Ltd	Automobile dealers	Services	360	42.265				Labour problems with long term settlements Political party intervention High power tariffs High cost of land Slow bureaucratic processing
Balmer Lowrie and Co Ltd (100 % central government enterprise)	Container manufacturing for shipping	Manufacturing	350					Closed down in 2000 due: High labour costs Restrictive labour practices Low productivity Foreign competition
Hindustan Pesticides Ltd (100 % central government enterprise)	Pesticides manufacturing	Chemicals	700					Low labour productivity due to job security in a government company Labour union intervention
Sud Chemis India Ltd (50/50 venture between central government & German company)	Chemical catalyst for Petrochemicals	Petrochemicals	145	4.227				High labour costs Restrictive labour practices Labour unions and political party intervention
Popular Automobiles (Kutikanam Group)	Machine tools & engine rebuilding	Manufacturing	800	126.796		Some facilities based in Karnataka	Labour unrest Labour union interferences Better financial & tax incentives	

Company	Description	Sector	Number of Employees	Annual Turnover (Million USD)	Initial Investment (Million USD)	Jobs created in other Indian States	Reasons for relocating	Barriers to growth
Synthite Ltd*	Spice extract, natural food colouring & oleoresins	Food & Beverage	384	32.333		100 jobs in Tamil Nadu 45 jobs in Karnataka		
Sun Metals								
Indsil Auto Components Ltd	Auto parts	Manufacturing		5.917		200 jobs in Tamil Nadu	High labour costs Poor infrastructures Poor government incentives Poor access to raw materials	
Binani Zinc	Zinc processing industry	Metallurgy	467	51.775				
Appolo Tyres	Tyre manufacturing	Tyre manufacturing	2,000	116.230		Shifted to Gujurat (1991) and Pune (1995) in order to improve negotiating power with labour unions and political parties		Labour unrest High wages
TCM Ltd	Chemicals manufacturing	Chemicals	350			2 factories in Tamil Nadu (1966 & 1979)	Access to raw materials Low labour productivity Labour rigidity High energy costs Competition with China	
R.K. Latex (joint venture with Malaysian private company)	Rubber producer	Rubber Producers		10				High tax on Latex (11%) Poor infrastructure High interest on borrowing Poor government support Political party intervention

Notes:

1. Please note that any firm that has less than 500 employees should be classified as a small firm. Anything beyond 500 and above should be classified as a medium firm, with the exception of Harrison Malayalam and FACT, which are to be classified as large firms.
2. Annual turnover rates refer to the year ending 2000

* Refer to companies identified by Dhanam Business Magazine amongst the top 50 firms in Kerala State in 1999.

Mexico State's Economic and Political Transition: From Entrepreneurial State to State of Entrepreneurs

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Abstract

This paper has the purpose to analyze most recent economic and political changes in the Mexican States, which show a clear transitional tendency from an entrepreneurial state toward a state of entrepreneurs through the following stages: The PRI-presidential Mexican Entrepreneurial State with an emphasis in the welfare state model, followed by a period marked by the transition of the Mexican State focused on a neoliberal PRI-presidential reinventing of the state, as the result of the economic and political impact of globalization and its pervasive effects on an unequal income distribution, weak governance, political instability and lack of property security, besides a new relation's interface between government and enterprises. Finally, the regime's transition under the change of party in power opens the stage of a Mexican State of Entrepreneurs in the new period PAN-presidentialist.

Introduction

Mexico is a highly centralized country with a powerful government, no reelection or, until recently, strong, open political competition. Since independence and for the last two centuries the dominant political system in Mexico has been authoritarian and presidential. Starting with the governments emerging from the Mexican Revolution (1910-17), it settled on a system of dictatorship in which the dominant party monopolized political representation and a deformed presidency. Krauze denominated the Imperial Presidency, weakening the legislature's ability to carry out its functions and duties, and diminishing judicial power. Various forms of patriarchal power represent yet another feature of the Mexican government before and after the Mexican Revolution.

The Mexican Entrepreneurial, Pre-Presidential State

Mexican economic nationalism emerged as a result of promoting public and private Mexican capital to avoid foreign investment, mainly by the United States. The Mexican State was characterized by an historical distrust of capitalism and a belief in the ability of the government to intervene and regulate economic affairs through its explicit constitutional mandate ?11?. However, from the 1930s and until the 1970s a model of import substitution industrialization (ISI) favored private Mexican investments and was also believed to benefit the people. The Mexican public sector enlarged the number of publicly owned corporations. In 1982 state owned enterprises produced 14 percent of gross national product (GNP), received net transfers and equal subsidies of 12.7 percent of GNP and represented 38 percent of investment in fixed capital.

In the name of the great conquests of the Mexican Revolution, during the time of the Mexican welfare state, organizations were constituted that corporately grouped militias, peasants, working class and popular sectors which exerted political control over the state's party bureaucracy in power and the "charro" (Mexican horsemen) leaders. The "charrismo" (a scornful term for union leaders) forced workers to conform to the rules of the official party, the Institutional Revolutionary Party or Partido Revolucionario Institucional (PRI). The workers were pressured and threatened with wage reduction, loss of employment, benefits, agricultural credit, increase in urban and rural poverty, etc., to guarantee their loyalty and a reserve of votes.

Although since 1929 all the Mexican presidents came from the Institutional Revolutionary Party (PRI), economic policy did not follow a regular and coherent pattern of policy making. Nevertheless, during the period of the hegemonic PRI, the government cultivated a degree of social consent that avoided extreme levels of repression in what has been called the "perfect dictatorship". In line with the so-called meta-constitutional powers, the President of Mexico was also the true head of the PRI and had, as his duty, designed national leaders and candidates for popular election. The Mexican president had both extensive constitutional and unwritten supra-constitutional powers and was committed to the retention of his political power during his mandate. The continuation of his power required him to follow the "ritual" of choosing his successor.

As the ruling political party, in the sense that it dominated the country's political life, the PRI held power in the federal executive branch of the Mexican government for 71 years. It was the center of the Mexican political system and used political mechanisms to control workers, peasants, the popular sector and organizations, such as "cuadillismo" (leadership), corporatism, etc. Also, the PRI enforced institutional control mechanisms over the electoral process. The PRI's corporatism focused on workers and peasants whom it promoted but did not liberate, guarantying them patrimonial rights and, with the pretext of institutionalizing the Mexican Revolution, identifying the causes of democracy and social justice with trickery. Its success in both areas was very poor, although they did maintain social stability. Each president in turn appointed his successor through a phenomenon known as "tapadismo" (overcoat candidate) and "dedazo" (finger pointing) to signal who was chosen.

Such analysts as Abascal and Macías ?2? identified three stages in the PRI's evolution: Hegemonic, bipartisan, pluripartisan. During the hegemonic stage, from 1929 to 1979, the infinitely superior PRI dominated over the other political parties and maintained total control of political power. During the bipartisan stage, from 1979 to 1985, the PRI maintained dominance over political parties of the opposition but lost seats in municipal and state governments to the National Action Party or Partido Acción Nacional (PAN). During the pluripartisan stage, from 1988 through to the end of 2000, it opened up political competition between the PRI, PAN and the PRD (Partido de la Revolución Democrática or Democratic Revolution Party) which shared power in municipal and state governments.

The effectiveness of the "perfect dictatorship", according to Vargas Llosa, or to the presidential monarchy (Ortiz Pincheti, 2000), was best demonstrated during an era of prosperity which coincided with a period of stabilized development, from 1940 to 1970, and a period of shared development, from 1970 to 1982. During both periods there were great advances in social policy, although poverty and social inequality were never eradicated, and a strong middle class emerged and claimed its place in political participation. The "perfect dictatorship" was underpinned by the shedding of the blood of the marginalized Mexicans. The State model, which distributed power and had emerged out of the Mexican Revolution, culminated in a crisis that degenerated into institutionalized violence.

At the end of Echeverría's period (1970-76), after 22 years of monetary stability and sustained growth, the peso (Mexican monetary unit) was devalued, an economic crisis began, and the constant tensions between entrepreneurs and government officials became crucial elements in initiating change. The entrepreneurs founded the Consejo Coordinador Empresarial (Entrepreneurial Coordinating Council)(ECC) to defend their interests from State intervention. In 1982 in the middle of a general economic crisis caused by a fall in oil prices, President López Portillo nationalized the banking system, devalued the peso, and increased interest rates. The country defaulted on practically all payments causing a fracture in the pact between the State and the ECC.

Transition of the Mexican State: Pre -Presidentialist Neoliberal Restructuring

Much of Latin America experienced financial crisis in the 1980s and the mid-1990s. In Mexico, intense economic crises occurred in 1976, 1982, 1987 and 1994-95, with intervening periods of mild economic recovery. Mexicans suffered periods of dramatically high inflation, external imbalances, devaluation, currency flight, increasing unemployment and declining purchasing power.

Since the beginning of the eighties the pressures on Mexican creditors to guarantee payment of external debt resulted in the creation of an instrument, the so-called "Washington Consensus", which imposed infallible neoliberal rule over a free market and a democratic system with free elections. Thus the "neoliberal agenda", which proposed structural adjustment programs and economic stability, was imposed by international financial organizations, such as the World Bank, the International Monetary Fund and the Inter American Development Bank, as a condition for negotiating the Mexican "debt crises" of 1982, 1987 and 1994-95.

Therefore, after the 1982 crisis, Mexico entered into a painful, distressful, and controversial period of state restructuring. The changes included: economic reorganization; national market openness; elimination of commercial barriers; elimination of price controls and subsidies; privatization of public enterprises and state property; reduction of social policy expenses; free money exchange, and also wide political reforms and administrative modernization. It abandoned the import substitution model and called economic intervention in the state into question.

The main thrust of the reforms encouraged in Mexico was the development of a competitive, broad-based export sector of nontraditional goods. Mexico joined the General Agreement on Trade and Tariffs (GATT) in 1986 and became an exporter of manufactured goods. The strategies adopted for the design of the Mexican State, as it was for other states, was reduction of state structures and facilities, privatization of state owned enterprises, and economic deregulation.

With the introduction of these reforms the Mexican State began to loose its capacity to function as a nation, although the State maintained that there are high indicators showing that the reforms benefited the owners of capital. These reforms to the structure of the Mexican State's apparatus make sense out of its transition and change from the welfare state model toward a neoliberal state model. This transition and change are understood, in Roitman's terms, as forms of behavior, loss of centrality in politics, loss in the ability to build a sense citizenship, transformation of politics into one electoral technique, and an increase in market problems. Also, a loss of ethics and principles in the work of politicians and political institutions evidently appeared in Mexico during the government of Miguel de la Madrid (1982-88), continued with Salinas de Gortari (1988-94), and also with Zedillo (1994-2000), and now with Fox (2000-2006), ?3?.

But the crisis of 1982 was also meaningful as the "crisis of hegemony" which was present in the old alliance between the State and ECC who represented national capital and were the direct beneficiaries of economic policies based on the import substitution model. Nationalization of the banking system was the main event that provoked the rupture between the political and entrepreneurial hegemonic blocks and their representatives, the politicians and government officials from the party of the State and the factions that controlled capital. As it is said by Fazio ?9?, they were living in one tortuous lover relationship of subterranean blurred tides, intense shady deals, and complicity networking.

With nationalization of the banking system Mexican capitalists, who felt betrayed, broke their alliance with the political bureaucracy and designed a strategy for their own re-constitution. The reinvention of the new Mexican State was initiated under the impulse of an intervening state with a strong neoliberal technocrat orientation, to the benefit the owners of capital. The process was based on neocorporatist negotiation between entrepreneurs and government, and built on mutual interests and compromise.

Economic and Political Impact of Globalization on the Mexican State

Under the influence of the PRI, the Mexican State initiated economic modernization and participation in the globalization processes, as a response to the trends of the economic globalization of markets, and the technological revolution that began during the last two decades of the past century. Under the pretext of cleaning up the economy, the Mexican State privatized strategic enterprises of the public sector, most of which were acquired by foreign investors, who had already penetrated all economic sectors. The high concentration of capital in a few corporations through the privatization process of public enterprises unleashed the phenomena of political privatization.

In 1987 inflation reached 159 per cent and a drop in the stock exchange devoured savings. Inside the PRI, a dissident group formed called the Democratic Current (Corriente Democrática) that later split to form a new party, the Frente Democrático Nacional (National Democratic Front) (NDF). President Miguel de la Madrid Hurtado (1982-88) was the first to stand questioning in his sixth and last term in government. On the sixth of July 1988 Salinas achieved power by controlling the election, i.e., where electoral irregularities and fraud were reported, resulting in a general crisis and the collapse of the political system.

Salinas deepened neoliberal reform and public enterprises were liquidated, economic openness was accelerated, and free commerce agreements were signed with Chile, the United Sates and Canada (NAFTA), Venezuela and Colombia (Group of Three), Costa Rica, Nicaragua and Bolivia. Amendments to Constitutional Article 27 allowed investments in the Mexican countryside. The activism of the Mexican State during Salinas' mandate allowed the transfer of public enterprise to financial groups which were determined to maintain links of political complicity.

Vast programs for the privatization of public enterprise in Mexico had been successful, to a certain point, in ameliorating the economic intervention of the State. Mexico ranked second in privatization in Latin America during the decade of the nineties when the government transferred to private corporations assets that amounted to 31,458 million dollars, which represented 20.4 percent of the total sales of state owned enterprises in Latin America. Privatization reached 3,160 million dollars in 1990, increased to 11,289 million in 1991, and totaled 6,924 million dollars in 1992.

By June of 1992, the Mexican government had privatized 361 out of approximately 1,200 enterprises owned by the state. Privatization during 1993 represented 2,131 million dollars. In 1996 it increased to 1,526 million dollars, in 1997 to 4, 496 million, and in 1998 decreased to 999 million dollars. A report from the World Bank states that between 1990 and 1998 privatization of public enterprises reached a total amount of 154,225 million dollars, an amount only less than the balance of the total external debt of Mexico which in 1998 was of 159,959 million dollars.

The year in which the state recorded most privatization was 1991 with a total of 11,289 million dollars, while in 1998 Mexico the lowest was 999 million dollars. The new government of Mexico plans to privatize airports, railways, and the energy sector, oil and electrical industries.

The benefits of privatization have not yet been evident to the Mexican people even though defenders try to demonstrate the opposite. According to data provided by Salinas de Gortari (1988-94), privatization reduced budget expenditures to finance social programs thus preventing a fiscal deficit. However, the effects have not been satisfactory over all. Programs of privatization in Mexico have reduced employment by half, while production has increased 54.3 percent with a significant reduction in investment. A study by Galal et al (1992) analyzed the after-privatization performance of twelve companies in different countries, including Mexico, and documented an increase of 26 percent in profits in eleven cases but an increase of benefits to workers in only three of the cases.

On the 17th of December of 1993, the United States Congress approved the North America Free Trade Agreement (NAFTA). Reactions were not long in coming. On January 1st, 1994, the date on which the Agreement came into force, the indigenous people of the State of Chiapaz created the National Liberation Zapatista Army (Ejército Zapatista de Liberación Nacional). Quarrels, resentment and bitterness between political groups inside the PRI resulted in the assassination of the official candidate to the Presidency of the Republic and the assassination of the General Secretary of the PRI. Even with these conflicts and serious problems the economy remained stable and Salinas was elected to his sixth and last term in 1994 with victorious animosity. Zedillo became President with 17 million votes, the greatest democratic legitimacy given in the history of Mexico. But, after twenty-one days in power, Zedillo faced the worst economic crises in the history of Mexico, the so-called December's Mistake.

Two years after the privatization of its banking system, in December 1994, Mexico was forced to devalue its peso which set off a macroeconomic crisis characterized by increased exchange rate volatility, further devaluation of the peso and was followed by a financial sector crisis and bailout. The meltdown of the Mexican stock exchanges resulted in the loss of half of the stocks value and share prices, for major Mexican companies quoted on Wall Street, dropped 75 percent within a few months. However, after this situation was resolved a deeper crisis in financial markets came in the form of the devaluation of the peso and the sovereign-default crises. The majority of the governmental crises, without a degree of investment (as is the case of Mexico), were caused by characteristic weakness in governance. If local people and foreign investors fear the Mexican peso will be devalued, they may convert pesos into dollars.

The new structure of State debt, during the Mexican crisis of 1994-95, has been studied widely in order to understand the way in which financial markets, governments, and multilateral institutions respond to the new questions of governance. The Mexican crisis raised the problem of sustaining fixed exchange rates in an environment of high mobility of international capital. Mexico did not recover because its weak financial system was strengthened through the intervention of the International Monetary Fund (IMF). It recovered because it had benefited from increased exports to the United States as a result of NAFTA and the accelerated growth of the neighboring U.S. economy.

The economic crises through which the Mexican economy has passed, aside from the inability of its institutions to limit the range in social problems, have caused repercussions on the application of neoliberal economic policy and are the key factors in the deterioration of social governance. One of the most pervasive and disturbing aspects of economic crisis is its effect on the most vulnerable population groups. In general terms the economic policies implemented by the majority of Latin American countries present similar features, although there are some differences in the design of the packs.

Although the causes and consequences of the different economic crises, through which Mexico passed from 1976 to 1994-95, have differed the crises were preceded by periods of high economic growth that could not be sustained because of the imbalance the crises caused. The crisis of 1976 showed the limitations of the economic model that was based on the principle that economic growth depends on major state intervention. The crisis of 1982 began with the idea that oil could be used as a lever for economic development and resulted from an active policy that the State should administer abundance. This resulted in high degrees of external indebtedness and an irrational expansion of the state.

Both the international debt crisis of the eighties and the Mexican crisis of 1994-95, also called the "Tequila effect", are considered to have their roots in the financial imbalance in the public sector. But in comparison, the later crisis (Asia, Russia, South Africa, Brazil, etc.) had its roots in the financial imbalance in the private sector and is considered the first global financial crisis to impact the economies of emerging countries. The Asian crisis exploded just after the crisis that lowered the Mexican peso. It therefore seems that financial crises occur more frequently in the later years of emerging economies, such as was the case in Mexico.

If the democratic social development and the economic growth of emerging countries is controlled, they are not significantly more corrupt than more developed countries. The pack of credits given to Mexico in 1995 by the IMF was a reward for banking with more risk. While more governments of other countries lend to Mexico, their banks have more security to cover their loans. In reality, the privatization of the banking system into financial groups emerged from the "steam" and complicity among investors and politicians who took advantage of international organizational finances channeled to rescue Mexico from the debt crisis. However, their differences in crisis management took them into highly indebted economies, which had the opportunity of transferring charges to society.

In 1995, as a result of these events, a program to modernize public management and eliminate corruption, decentralize public functions, and reorganize intergovernmental relationships within the federal system, was initiated in Mexico. The monopoly of power and its discretionary use, retained by some members in the structures of government, were still the main source of corruption with impunity, therefore deep institutional reform was required.

The program pretended to develop mechanisms of major responsibility and accountability for governmental agencies, in the matter of management of public services, and also to ensure the major disposition of established associations with non-governmental organizations. It is necessary to consider that these non-governmental organizations were the base of credibility and impartiality before the citizens whom they represented in human, political, labor, and citizen rights to governments that sustain poor relations, emanated from the PRI which always tried to incorporate them when they were more independent.

In 1996, public and private investments in Mexico were kept under the levels of the seventies and eighties. The results of the globalization processes confirmed that it had gone in only one direction: the entrance of transnational and multinational enterprises, now called global enterprises or contemporary business, which in essence are foreign, have taken legal ownership of the natural resources, land, etc., and returned few benefits. For example, the market value of General Electric calculated at 520,250 million dollars, is equivalent to the GNP of Mexico. In fact, 23 of the greatest transnational and multinational corporations have sales that are higher than the GNP of Mexico. Neoliberal governments have shown their inability to reduce the pain of the integration processes through more favorable negotiations that would allow comparative and competitive advantages for Mexico.

Damned Inheritance

At the end of the period between the years 1982 and 2000, which marked the development and implementation of the Neoliberal State model in Mexico, the results were disastrous. Although there were achievements in economic growth during the last four years, 1994-2000, the Mexican economy showed several structural imbalances as expressed in a corresponding fiscal deficit. As Lomas ?17? affirmed, President Zedillo's inheritance also included the great pressure of debt service from the financial rescue that will exercise influence over public finances in the medium term. Lamentable as it is foreseeable the present administration will leave an inheritance to the next government of a greatly compromised public finance and an even greater inability to respond to the reasonable demands of the people. Zedillo´s inheritance amounts to more that two billion dollars (million, million dollars) in public debt, including the wasted debt of the Institute for the Protection of Bank Savings or Instituto para la Protección del Ahorro Bancario (IPAB).

Interface Government – Companies

In Mexico, the main obstacles for managers are continued crime and robbery, because of an inadequate infrastructure, inflation, corruption and lack of financing. Many companies still do not pay taxes.

Unjust Distribution of Income

According to Cepal's estimates President Zedillo left a country with an increase in the difference in income distribution, i.e. high wealth concentrated in a minority and poverty in the majority, from 40.5 to 45.5 million Mexicans. Of these, 26 million are mostly indigenous, rural, and live in misery. The contradictions were caused by polarized growth, according to Boltvinik an expert on poverty and income distribution in Mexico. He stated that, "When the economic pattern that has been followed up to this point in Mexico is able to generate growth it will be accompanied by a growing concentration of income and an increase in poverty among the poorest strata. …the crisis of 1994 produced a brutal impoverishment of the population…until 1996, when the economy began to recover, and income again began to concentrate….". In a period like the current one, in which the Mexican economy reached a peak over 18 consecutive trimesters of growth, the benefits went to a very reduced group of people: "only the crumbs fall down" states ?12?.

Poverty increased from the 36 to 38 percent of the total of Mexican homes in 1994 from 45 to 47 percent in 1998. Data from the National Survey of Income-Expense in the Homes (ENIGH) of the National Institute of Statistics, Geography and Informatics (INEGI) indicates that between 1994 and 1998 the number of Mexican homes subsisting under the poverty line with a monthly income no larger than 560 pesos at a constant value of April 1994 increased from 69 to 76 percent of the total population. In general terms, the investigators agreed that poverty increased by more than 5 percent during Zedillo's term in office. This resulted in a society with big contrasts in income distribution, where 20 million Mexicans (20 percent of the total population) live under conditions of extreme poverty, and more than 40 millions (40 percent of the total population) live below the line of poverty.

In the last three six-year terms the rate of inflation has risen above the increases to the contractual minimum wages and, therefore, above the level of the workers' income. World Bank figures show that 42 million Mexicans have salary levels below twenty pesos daily, the equivalent of less than 2 dollars a day. Between 1974 and 2000, the real wage of the workers had an accumulated deterioration of 72 percent. During Zedillo's government an accumulated loss of 50 percent in real wages was recorded, registering the lowest purchasing power in the last 18 years. With data from the United Nations organization, 64.5 percent of the population received insufficient wages to sustain minimum nutritional requirements; 40 percent of Mexican women live in homes with low income compared to 20 percent of Mexican men ?15?. More than half of Mexicans old enough to work were employed in the informal sector of the economy.

During the period 1964-1981, the gross internal product per inhabitant rose to 7,776 dollars a year, with an average annual growth of 3.4 percent. However, after l982 with the implementation of the Neoliberal State model in Mexico, the growth of the gross internal product fell. For the period of the Neoliberal State, which lasted from 1982 to 2000, the gross internal product per inhabitant only grew on the average of 0.3 percent yearly. The National Survey of Income-Expense in the Homes, carried out by the National Institute of Statistic, Geography and Informatics (INEGI) in the year 2000, reports that the generation of wealth increased in the last six years, but the distribution of the wealth became more inequitable, with alarming levels of deterioration.

In Mexico 38.11 percent of national income is concentrated in 10 percent of the homes. At the other end, 10 percent of the poorest hardly receive 1.50 percent of the total, when in 1996 it was 1.79 percent. The income available monthly to 10 percent of the poorest homes was 26 percent less than in 1994, while for ten percent of the homes the reduction was 20 percent ?12?. The coefficient of GINI for the monetary income in 1992 was 0.5086, in 1994 it was 0.5137, and in 2000 it was 0.4889, which indicates a tendency in the concentration of the national wealth to decrease, though those with more however continues being high.

Quick economic growth has not resulted in an improvement in the levels of the population's standard of living, due to the inequitable distribution of income that impedes the transfer of macroeconomic benefits. The higher rates of growth that reached four percent, on the average, of the gross internal product between 1996 and 2000 has not contributed to improvements in the well-being and standard of living of the family, because they contribute 2.4 real percent of the product per layer. According to an analysis of The Financier (2000), for each peso (Mexican currency) that was generated in the economy in the first trimester of the year, 0.07 cents corresponded the population with scarce resources (38.11 percent), while the population with high levels of revenue (10 percent) obtained 50 cents.

Since 1994 when NAFTA was signed regional development has also been inequitable and unbalanced, subject to processes of economic separation that were the result of integration with markets of the North. Mexicans with lower revenues per layer are concentrated in seven States in the Southeast of the country. They represent less than 10 percent of the national gross internal product, while with a similar population, six States in the North generate 23 percent of the national wealth. The pattern of export growth based on cheap manpower allows only that small group of companies to benefit from the commercial treaties between Mexico and other countries.

Weakness of Governance

Weak governance in Mexico, for example, had its beginning in the weaknesses in the spheres of economics, society, culture, education policies, etc. and in the weaknesses of government institutions, although in the past the Mexican State was strong in creating institutions and public policy. The characteristic weaknesses of governance, were official and private corruption, influence peddling, corruption and inefficiency in the judicial institutions, and the influence of drug cartels. Moreover, deficiencies existed in internal security in the form of guerilla groups operating in rural areas and violence in the big cities.

The governance deficiencies were related to the uniqueness of the political system, which had its origin in erroneous economic policies implemented by the wealthy, who then created the organizational design for the transition of the Mexican State. Mexico has lived with the people focused more on the ideas of its rulers than on concrete proposals for national development through institutional development. The Mexican State has been able to maintain its uniqueness by making political promises that offer social protection on the one hand and more benefits that would favor the diverse social groups on the other.

Political Uncertainty and Security of Property

In Mexico's specific case, a consistently high factor of political risk (qualified as " BB ", non-investment degree) is the quality of governance that embraces the quality of the public sector's institutions; the efficiency of government services and the government's capacity to establish macro-economic stability. In an analysis of the dynamic factors, the estimate of the monthly national risk index is the decisive criteria for calculating the ratios of imports to reserves and debt to exports. Socio-political uncertainty is an important component of national risk.

Another important aspect to determine is the uncertainty involved in the regular transfer of government in order to evaluate the possible uncertainties caused by elaboration of the laws. The government's constitutional position (as a result of elections) is usually accompanied by big changes in the rules and regulations that impact on business.

With regard to the uncertainty in equitable application of the law, it is important to determine if companies trust the ability of the authority of the State to protect their property rights and to guarantee a dependable judicial process. Robbery and crime are serious problems that can substantially increase the costs of doing business and there is no trust in the authority of the State to protect people and their property from criminal acts. The unpredictability of the judiciary presents an even bigger problem for business operations. Public insecurity in Mexico has put the country into a situation of near chaos, surpassing other institutions that are pillars of an already decomposing system, as in the case of the PRI.

The governments' years in power leave behind "open wounds in the national conscience" from the indigenous conflicts of Chiapaz. The result being: increasing levels of poverty, the growth of the informal economy, increase in violence and public insecurity, corruption with impunity, the precarious conditions of micro, small and large enterprises and the deterioration of the countryside and farming sector.

In sum, the current problem in Mexico is good macroeconomics but bad microeconomics.

The Transition of the Régime of the Mexican State: From State Manager to a State of Managers

The pattern of the State party, and more concretely of the Mexican PRI-State, has ended. The failure of the PRI to form the federal government and their loss of an absolute majority in the Union Congress in the last elections was an event that constituted a new stage in the life of Mexico by placing the alternative National Action Party (PAN) in political power. Unlike other changes in power that have taken place in Mexico this one has been a peaceful road taken in an atmosphere of political stability, culminating in the arrival of a party contrary to the one that had held power.

During the last four administrations the transfer of power under conditions of economic and political stability was not evident. First it was necessary for the PRI State to disappear. During the last sixty years change occurred more within the party than in the political régime centered in a State party, characterized as a hegemonic political party. The PRI was a hegemonic party that held power for a period of seventy-one years, from 1929 to 2000. It served to sustain a presidential system with meta-constitutional powers, omnipotent above other powers (legislative and judicial) and over the spheres of economic life, politics, society and culture.

For the government to change required agreed upon and sometimes not agreed upon accommodations between the political and economic interests. First, the President relinquished constitutional powers and the system of patronage, established by the PRI and given to all the presidents who had emerged from within its ranks. However, the changed governing party retained the same presidential structures derived from the political culture of the Huei Tlatoani, or supreme lord, who ruled over the military, civil and religious life of our Aztec ancestors. For the political culture and government régime to truly change, structural transformation of the laws of public administration would be necessary, as well as strengthening legislative power, freeing judicial power and delimiting executive power, especially presidential control over the government and the State.

In the last two decades, since the eighties, amid major financial crises and a neoliberal agenda to change economic policy, growth stopped and its decline accelerated during the last four years of the nineties. This resulted in big imbalances in the economic processes and the dismantling of the defense mechanisms of the Mexican State. During the decadent stage of the PRI-presidential system, corruption increased, social cohesion was destroyed and the levels of poverty increased alarmingly. Income became increasingly concentrated "in favor of a minority coinciding in its composition and voracity with the elite of Creole inheritors and beneficiaries of the colonial caste system and of the porfirista system." So, in part, the defeat of the hegemonic PRI party was due to the collective rejection of economic policies that increased the levels of poverty, corruption and social violence. The PRI lost its capacity to respond when faced with a more active civil society.

Zedillo, the last PRI president, "cut his finger" to indicate that his successor inherited the power to allow the tri-colored candidate's election. He was not able to stop the buying of votes or coercion of the voters. But he did discipline the most reactionary to impede their stealing the election again and then, when losing in the war with the other parties, to open the way to a democratic transition that would reinvent the system. In a few hours it was transformed from a hegemonic party and authoritarian government régime, to a more democratic system, concluding the process of democratic transition, and handed over power in conditions of political normality, without any uncertainty about the change of the government or regime.

The transition occurred from a single party system to a democracy. However, this democratic transition was questioned to a certain extent, because what really happened was a change of the party in power. In any transition, it is evident that the total abdication of those powers that have to do with the control of the political process would leave a power vacuum resulting in adverse consequences. Still more, it remains to be seen if the democratic system improved the living conditions of Mexicans. Certainly, there was not a change of political régime, but a deepening of the neoliberal economic policy that had already been applied in Mexico since the middle of the eighties. The 71-year era of the hegemonic PRI party ended and it is expected that it also ended the Mexican presidential era.

The change to democracy after sixty years under the same political régime and the same access to political-power, has modified expectations and the operation of national public life. These changes have partly been the result of filling the vacuum created by the political party that had been in power. However, the form of the election was highly questionable in that it appealed to the "useful vote", and not to the "ethical vote based on principles and projects." PAN built its own place in the electoral market by conditioning voters to accept the falsehood that it was time for a change. They explained that "it didn't mean that they were in contention with neoliberalism but their only goal was to shoot the PRI out of The Pines" ?26?.

For some skeptics what happened was simply a change in the way of doing things, rather than in the content of what is being done. By all means possible during its last three years it was the satanic PRI that sold the depoliticized youth on the idea of the necessity and possibility of altering political power to create scenarios which would multiply opportunities for social mobility, education and employment for them.

The change of political party within the same régime represented a rupture in the old Mexican political system and continuity of the processes of development according to the neoliberal pattern imposed by the interests of transnational capital. This way, the change became significant because it represented a final balance between a presidential régime and its neoliberal economic model.

With the change of party in power came the end of the PRI era that covered a period of seventy-one years, already well known as the era of the dinosaurs with 22 presidents from the same party. Members of the "revolutionary family", had a patrimonial governing style with investiture and where public goods attributed to the public position were considered personal property. As well as paternalism the chains of corruption and complicity facilitated political control through corporate practices, clientelism, and the corruption of those who had less resources. The corporate interests that conditioned the votes of citizens also oppressed their political and human rights. It is interesting to analyze the different presidents' careers, the first from the military, who gave way to lawyers, then to economists and finally a manager.

When considering the change of the Presidency of the Republic, the end of the first sixty years was different from the last four years that left an inheritance of economic crisis and political deterioration, although political decomposition, violence and corruption still persist. In the last two six-year terms, that of the technocratic presidents who privatized politics, Salinas (1988-94) and Zedillo (1994-2000) truly represented the two big local groups of officials and managers politically. The two technocratic presidents had as a common governing characteristics a personal focus on social and power relationships. Both fostered the emergence of complicity between the technocrats and managers enlarging the capital-politics relationship to the men that held economic power, without respecting the rules of the system or the correlation between social forces and politics.

The Mexican technocracy has been insensitive and indifferent to social problems. Both, Salinas and Zedillo can be identified more as administrators or managers of economic politics than as rulers. The strategy they used to implement the neoliberal model consisted of maintaining a reduced group of technocrat economists in a network of alliances in collusion with capitalist groups. These capitalist groups, those whom Ortíz Pinchetti ?21? named the nomenklatura, had insatiable financial interests and were the main beneficiaries of the model. In Salinas' strategy, through the support of PAN, political leverage was given to the group of managers and financiers. It was their mega-negotiations with Zedillo's group (Grove, 2000) which killed the PRI. The decentralization of power began with Salinas and was deepened by Zedillo. Together they consolidated the neoliberal economic model.

Salinas first and later Zedillo, governed with authoritarianism to implant the economic policy imposed by supra national institutions. They were flexible in politics where they enlarged political freedoms for pragmatic purposes, provided they didn't contravene economic policies. The principle was stated this way; all economic reforms without political reforms are insufficient and result in dangerous contradictions. The modernization project of the technocratic presidents, neoliberalization and globalization, were promoted by the PRI governments. The government paid dearly because it gave up power and was not able to give benefits to most of the population because the modernization project was sustained by a substantially different economic order and guided by the governments that emanated from the Mexican Revolution.

In Zedillo's the sixth term in office the Deputy of the opposition, Batres, accused him of seeking to be a "Robin Hood the other way around, robbing from the poor to give to the rich…." The neoliberal governments confirmed that they acted in way which was "wicked, nothing moved them and their biggest works were the businesses that in some years allowed some to be enriched" ?27?. But the unusual thing was that the same PRI parliamentarian factions abandoned the old habit of defending their president to criticize the mistakes and inefficiencies of their administration. Social dissent could only cause loss of the neoliberal modernization project, which supposed a 25 year period of adjustment, during which time they sought conserve power, based on the control of the incomes of the working people and not of capital.

In the 2000 elections, for the first time in 71 years, the PRI lost the presidency of the Republic. This was a transcendental event for the political life of the country because it radically changed the political perspective and national expectations. The defeat of the hegemonic PRI party, which "progressively destroyed social cohesion: normally expressed and implicit, that held us together as Mexicans was due to the government's inclination to favor the Creole oligarchy and the concentration of monopolized capital" ?22?.

On the other hand, Touraine ?29? argues that the result of the elections put an end to the long reign of the PRI. It had reinforced the political action and intervention of the State in a country whose growth had not reduced social inequality. The economy grew but the benefits of that growth were not distributed, that is to say, it generated wealth but it also generated poverty. The opposite, the reduction of the weight of the State, was announced, although the public sector was traditionally weak in Mexico. Mexico's entry into the global economy increased the State's options for institutional change.

It opened up the Mexican political system for movement guided by the changes they had made, beginning with protest and public debate, more than a new political project. However, this democratic project could only be understood when viewed from the standpoint of political depolitization.

In fact, Fox's political and economic project gave continuity to the technocrats' project which was not more than a transition, because the only thing that happened was not a change of political régime but an alternate party in power. Given the conditions of the system the ideal thing would have been an alternate party with an alternative, a necessary alternative to government. In any event, political transition has been possible thanks to that same neoliberal model as disarticulated to civil society and citizens. What has happened in Mexico, according to several analysts, is that "a type of caudillista democracy has triumphed over a weakened left, marked by weak, unstructured political parties that reflect the decadent, centralist elite" ?20?. However, it is highly questionable whether the change has lead to a democratic régime and the death of a dictatorial presidential régime.

More than continuity, the pattern of neoliberalism increased with the Fox's rise to the presidency of Mexico. He represents a third movement of the neoliberal economy begun by Saline. Nevertheless, the technocrats were hit politically by the managers. The new political class, which mainly emerged from the local organizations of small and medium managers in the North, wanted to liberate the country from the corruption and clientelism of the State party. The Manager State was dismantled in the rise to power of the technocratic economists. Now with a manager-like President in Mexico, the Mexican State has become a State of Managers that treat democracy like good business, called the Coca-colaification of Mexico in reference to the managerial antecedents of Fox's transnational government.

According to a Canadian managerial leader, for Fox the governing of Mexico won't be the same thing as managing Coca Cola, but his managerial experience will help him to make decisions ?14?. The analyst Rubio ?16? describes Fox as "evidently a practical, pragmatic person who clearly adapts to circumstances. He has his priorities very clear and he has a clear sense of who to use and for what reason; he wants to use each one of the people. And in that sense what we see is a person not very ideological, not very dogmatic, but very adaptable to circumstances as they arise, moment by moment."

It is paradoxical that in a country where more than 60 percent of the population is poor, the elections were won by a party of the right that proposes to deepen the neoliberal model responsible for the increase in poverty. Fox's rise to power, coincides with the consolidation of a concentration process, an economic oligopolitation, and political centralization of decision-making ?9?.

With Fox the Mexican presidency is transformed from autism to democratic caudillism. Fox's ascendancy to the Presidency of Mexico, according to Krauze (mentioned by Fazio, ?10? resulted in "a direct, immediate switch to managerial power. Wines of new marketing in old wineskins of caudillism…a caudillism plebiscitary with messianic edges, very dangerous in a country like ours that finds the separation between the church and the State difficult". Nevertheless, the ghost of presidentialism has not gone away with Fox in the presidency. He has assumed an attitude of "commander of the town" because behavior patterns still exist that encourage it, reinforced by the existing Constitution. A true change in the régime implies a deep reformation of the State with a new Constitution, and in which diverse political forces delimit presidential activity.

Fox is the first manger president to arise out of the local elite from the center of the country. He represents the "electoralist stream" of the managerial elite in PAN and especially the stream dominated by the faction from the northern states or "Monterey Group". It has loose connections and is supported by the ideology of the new, Mexican right, as expressed in current pragmatism or neopanism, and is opposed to traditional orthodoxy. According to the ex-leader and twice Panista candidate, Pablo Emilio Madero, nephew of the democratic anti-re-electionist Francisco I. Madero, "Vicente Fox Quezada's eventual victory in the presidential election crowned the agreement of a group of managers. In 1982, these managers decided, in a meeting in Cd.

Juárez, Chihuachua, to infiltrate and control the National Action Party (PAN) to gain particular interests. The virtual ascent of neopanism to power constitutes a serious risk for Mexico because the pragmatic principle of personal interest would take precedence over common interests. And once in power they would be overcome by the temptation of authoritarianism to eliminate opponents, which would discourage the nation" [28].

Fox's proposed changes are considered imprecise as they relate to the panista proposal. According to Loaeza [25] "The lower and middle classes are described as not reactionary. On the contrary they want political change, would like a modern society, and are outward looking, though on the other hand, would be interested in a reduction of social inequality but not absolute equality, because that doesn't interest them. They have a vision of an anti-egalitarian society, they are not interested in equality but freedom. Freedom with order yes…social justice is not a panista topic…"

Contrary to the current doctrine, the ideology of neopanism, with certain flashes of fascism, defends the "changarro" from the attacks of official populism. With the focus on a distant political social democracy, the view is that the "useful vote" doesn't recognize the difference in ideologies but operates on the simple desire to reduce the power of the State Party. And under the representation of "virtual party unity", the political class is recomposed with the rise of the managers to formal power. The managers, mainly fom managerial unions in the North of the country, rose to political power using their managerial unions as launching platforms.

Nevertheless neopanism fought official populism and the decomposition of the Mexican political system was the main reason that a new, anti-party populism arose. According to Touraine [29], this political decomposition goes hand in hand with the advance of worldwide economic conglomerates. In the Mexican case it is also expressed as an alternative "to the Mexican" that, though difficult can be considered "like a real road for the creation of a true democracy." But in the aftermath of these political remarks, it is as dangerous to give priority to the fall of the whole substance of their régime, as it is to encourage the union that is already way too strong between a vague populism and economic liberalism. The resistance to this populist tendency attacks the political system at the same time that the capacity of the State to intervene has to be organized for popular movements. These popular movements have the capacity to manifest and to express the popular demands of the less favored sectors, in such a way that they really contribute to the restoration of public life.

The transition to the new régime has not been so smooth and soft. The caciques that held political and economic power weren't resigned to their loss. The death of the wounded PRI has ended in internal disputes over the little power that remains and the political groups defend their interests to their share of the power, resulting in violent confrontations. The smoothness of the political transition leads us to suppose a pact was made with those with real power.

Change of the Party in Power: The Mexican State of Managers in the New Pan–Presidencialist Period

The arrival of the managers to the Mexican State meant the displacement of politicians with formal power. In other words, what changed was formal power, because the real power remains unalterable. The Mexican Council of Businessmen stopped being a pressure group in the face of the power of the State and became instead the representatives of the managers in the federal government who determine national economic and political decisions. That is to say, the political power taken by the conservative groups that held hegemonic, economic power and the national neo-oligarchy was subordinated to the interests of transnational capitalism exercising a new governance strategy. This strategy allowed them to dominate and directly control the means for achieving their maximum benefit (efficiency), without necessarily appealing to the mediation of a political class that was highly paid for the mediation of the arrangements for production factors. This is the case between capital and work, for example. However, in humanity's history, the achievement of efficiency has not brought social justice.

The new State of managers administers the existing order efficiently to guarantee transnational global capital that the best conditions for investments exist in Mexico. Already the general coordinator of economic affairs in the transition team guaranteed "zero discrimination" for Mexican entrepreneurs. On the other hand, the leader of one of the most powerful organizations of managers warned that Fox's government would be friendlier to the production sector. Fox has a clear vision of the needs of a company, so he can create wealth and more work sources [5].

Fox represents the alteration of government and has stated that the purpose of his public administration is to increase efficiency in the government's work to a large degree and to eliminate all that has to do with error and corruption. “I will delimit the functions that reduce the effectiveness of government administration and damage of the whole society… …we have to put an end to political and administrative centralism and promote the invigoration of federalism to drive the development of the regions and the viability of municipalities, starting with their vocation and resources and the expectations of their communities.” ?19?.

His project of reengineering the federal public administration followed the advice of the World Bank. Based more on the pragmatism of changing the administration without changes to the law, it is sustained more by horizontal and flexible structures than by approaches to efficiency, effectiveness, opportunity, pragmatism and quality ?1?. The horizontal and flexible structure was articulated in a strategic plan reaching as far into the future as 2025. It combines managerial approaches with experience in the public sector. It was formed by super advisers and super managers who coordinate the work with regard to human development, security and justice, equal opportunity, and restoration of the government's institutions, general coordination, Czars (anticorruption and borders). It also formed Secretaries of State in government, social development, labor, companies and industrial development, agriculture, and country property.

On the other hand, the managers have declared ?5? they are convinced that the new government will be “friendlier”. They request options for participation in the investment deprived energy sector (electricity and secondary petrochemical). They reject that it seeks to recapture populist politics and they trust that the relationship is close enough that they will be critical when Fox makes a mistake. It is clear that Fox will govern the Mexican State with a focus on the New Public Management, as if Mexico was a corporation: Mexico, CORP. which gives the petrochemical and electric sectors to transnational global capital.

Fox's approach is frank and pragmatic. Madero qualifies Fox as “pragmatic, a man willing to throw ropes, say big words, buy votes, anything to win the election… in the name of pragmatism, and I worry that for him the pragmatic principle is more important than the democratic principle… (we) shall have to wait and see whether a panista government under Fox ‘will respect the people of Mexico for criticizing those who are… already in the government in power or he will do the same thing, which is to eliminate those that are opposed…” ?28?. Fox´s discourse was characterized by its open style and it broke with rigid protocol. His frankness, businesslike style and democratic genuineness are points in his favor. Fox has the intention of making his government a dynamic promoter of development, vigilant of human rights and pragmatic in administering domestic policy ?13?.

As a good manager, his pragmatism in solving problems is his main asset in achieving an “agreement” of the aspirations among the various sectors of society. But also his weak point is in negotiation. He tries to create “minimum points of outburst” where all the political actors simultaneously put on an air of agreement in economic and political matters. The proposals will be open to questioning by civil society and legislative power, where a majority doesn't exist for some of the political parties. It will be easier then to achieve cohabitation that won’t be unconditional to build the consent necessitated by lack of absolute control of the Congress. Fox has said in this respect, “my government won't make overall decisions in economic matters that will be against the interests of the majority. Nothing will be done without consent or behind backs or against the will of Mexicans” ?19?. In this sense, there is consent among the diverse political forces to delimit presidential power by suppressing his meta-constitutional power and creating an independent civil service free of the executive’s will.

But Fox’s pragmatism doesn't have an ideological base. It is be postulated on liberal values but the necessity of escaping the priísta cage, as stated in Reyes Heroles ?24?. Fox declared that his government won't be bitter and it has demonstrated that it is moving away from the demands interposed against him by those who accused him of receiving the foreigner’s money. Thus he confirmed certain rumors that came, in part, from former president, Salinas de Gortari ?18?.

The State’s managerial focus considers citizens as clients whom it must satisfy with services of absolute quality. The president exchanged the word client for that of citizen, with a vision on the one hand, for example, that it is inappropriate to promote the policy of indigenous community development. Disrespectfully, Fox has called the indigenous people “vocho, changarro and tele” in response to their centuries of rebellions against the capitalist system for the injustices perpetrated against them. To neoliberalism centered in the forces of the market, the indigenous peoples are not consumers. Therefore, they are disposable and, in the best case scenario, a population to be integrated or assimilated into the lowest ranks of the work force without rights and subordinate to capital, as exemplified by the proposal made during Fox’s campaign to train them to be “the foreigners' gardeners". Political analysts agree that "his proposals have been contradictory, sometimes retrograde, sometimes hopeful, but always lacking a coherence that would make the program complete. We have to be critical of a possible, new liberal version with some attenuation" ?22?.

In this way, the factions integrated into the directing elite were recomposed of managers to guarantee the continuity of the economic model, the dimensioning of a functional democracy that matches the discipline of the market, and the structural reinvention of the system. This allows a bigger reproduction of capital and deepening of the dominant instruments to markedly increase differences and social injustices. But this democracy favored by a authoritarian free market system is a hegemonic ideology of the elite of transnational globalized capitalism that imposes decisions to its own benefit. However the real power remains under the control of transnational capitalists.

On the other hand, the PAN in government will have to confront the issue of waste during the President's rule. There is evidence that Fox's governing style will be less flexible in politics and more authoritarian in economic politics than previous presidents, although he affirms that his priorities are to attend to the poor. Under this new correlation of forces, and with the same rules of separation of powers that established their autonomy, public matters are managed with more transparency. The frauds of the public sector and violence of the conflicts are now treated by the rule of the State and citizens can demand the right to the rendition of bills and transparency. Establishing the material conditions for law and order will be one of the government's challenges.

The organization of the new political system will be conditioned by economic politics. According to Bendesky's analysis ?6? the country reached a macroeconomic peak that lasted for more than four years because it "was sustained by factors hidden in the macroeconomic bills such as the high price of petroleum, the entrance of foreign currencies that reduced the dollar, and the dynamics of the economy of United States (which)… can change its tendency and pay the costs of the whole Mexican society when it is, of course, Fox's government. Among the changes necessary would be an adjustment of the exchange rate, increase in inflation, a bigger external imbalance and an inability to solve the problem of poverty." So the challenge is to maintain economic stability, to increase economic growth, support competitiveness and increase the productivity of the economic agents.

The political transition will come harnessed to economic reform but there won't be social advance. Structural economic reforms are needed to modernize the regulatory framework of general economic activity and strengthen the functional structure of the financial system. Cutting social expenditure in education and public health would reduce the weight of bureaucracy gradually by transferring these functions from the State to the private sector. Fox has said that they will reduce the cost of government in the next six years by subjecting it to a rigorous but gradual diet of federal public administration. Changes are needed to eliminate the lock on 51 percent of national investment to give a bigger opening to private and foreign investment and to invigorate the financial system.

Fox´s government committed to an integral fiscal reform and to tightening fiscal discipline. However, the IMF recommended maintaining "wise fiscal policies to assure the continuity of favorable growth and to avoid the risk of overheating their economy", ?23?. National development was sustained by fiscal reformation, based on the federal pact to assist in removing the inequalities of regional development, but this eroded the principle of solidarity.

Privatization and opening the energy sector to competition, especially the electric and petrochemical industries, won't work according to the same managers. "The country functions well… entrepreneurs don't want to buy Pemex or CFE. As a private sector what we want is to be allowed to compete, to participate in certain areas of production, to make them competitive at the international level… it is not necessary to put padlocks on foreign investment so that it intrudes in the electricity and hydrocarbon industries. The only rules for national capital and foreigners should be a free market economy, open commercial prices set by international competition" ?5?.

Under the focus of the New Public Management, Fox's government intends to deepen decentralization of decision-making by means of invigorating federalism, a post-PRI federalism to transfer to State government resources, abilities and responsibilities. In economic matters, this accumulation of resources, abilities and decisions gives place to what Zaid called "the Presidential Economy." The restructuring project and the federal government's reengineering are guided by an efficiency approach to the gradual reduction of the bureaucracy in order to optimize resources and to reduce the costs of operation.

The agenda of Fox's government is focused on eight strategic areas. These are restructuring of the Secretary of Government, modifications in the procurement of justice and public security, redefinition of functions in controlling public expense. Also, modernization and reformation of the energy industry (petroleum and electricity), redefinition of social development objectives, continuity of the economic project and reactivation of foreign policy ?7?. In general terms, the prevailing neoliberal economic policy has not been changed in the last 18 years, but rather it has been deepened. However, the project of restructuring the federal public administration assures that "none of the current public servants will be left in the street without employment opportunities" ?8?.

The Reformation of the State, the decentralization of functions and reorganization of government bureaucracy, are required to improve democratization, governance, public administration, and to impose the rule of law for legality and justice. The challenge to organize the government lies in building a system of multi-sector, matrix management of public administration ?4?. This can be done with a dual purpose: to coordinate the sector's actions and to redistribute the structures of local governments, attributes and abilities. Both have as their purpose the reestablishment of solidarity and social cohesion and the inclusion of the excluded social sectors in the benefits of development.

The new government's main challenge will be to build new institutional structures to solve the problems of the new reality that faces the managerial group in power. For example, those institutions that impede the practice of monopoly and that sustain governance of the Mexican society. This governance should be considered a democratic mechanism that facilitates relationships in the decision-making processes formulating and implementing public relationships, and establishing a harmonious relationship among the three powers. In political matters, it highlights the maturity of the electoral democratic processes, to achieve political reconciliation among the diverse political forces, to foment political and ideological plurality in the organs of the State, to drive the processes of decentralization, federalism, and regional and municipal development.

The new institutions that emerge from the government's decentralized reorganization should be guided to satisfy the demands of the citizens thereby opening channels for social participation. Also, to enlarge democracy by means of the recognition of its territorial environment and structures characteristic of public organization, the direct election of representatives, the assignment of abilities to the municipal government, the coercion capacity, the existence of untapped resources, and the direct administration of local services.

With a weak fiscal structure, financing of the basic functions of the State won't be possible. Other functions of the State will be transferred to civil society and to the market. Social expense will have a limited margin to maneuver to support such social policies as education, health, public security, and infrastructure. A public, lay, gratuitous education, based on values and quality, will be the axis of social politics. Fox will have programs and mechanisms that reduce poverty, achieve a fair distribution of income, recover real income, and translate into benefits for families by means of the generation of employment opportunities, financial resources, training, etc., for all. Philanthropic societies and the Catholic church will take charge of developing some of the functions given to the welfare State, when there existed a separation between the Church and the State, such as social attention to excluded groups.

The proposed democratic capitalist model for market economies in Latin American countries needs to be revised so that the function of the results is expressed in increments of poverty. Some of the main challenges for the rest of Fox's administration are to recover the government's credibility and genuineness in such a way as to reduce the high index of poverty by creating one million two hundred thousand new jobs per year, and to maintain economic growth and development. Correction of social inequalities is required starting with the reorientation of economic policies. One inevitable topic is how to draft public policies that will combat inequality in education, health, infrastructure, and housing.

It was necessary that the State should govern and act to rectify inequality, create a social economy that is a humane economy, and humanistic policies in the economic sense with a high emphasis on combating inequality. Economic policies should be drafted to generate good conditions of human life and not only change the bias that gives the market an indisputable hegemony and to guide certain production bases, but to make the State responsible for combating inequality. Economic policies have to become unified to reduce poverty through such measures as the establishment of Social Banking to support families and associated companies, as well as to create a government salary pact between employer and worker, that allows workers to recover their purchasing power.

A political system is required that will produce a public administration that is accountable to the people in such a way that rulers are brought closer to those they govern and which will permit social participation in the design and implementation of public policy. However, the conservative panista speech manages only to recognize the social participation of private philanthropic non-governmental organizations. Nevertheless this joint alteration of party power, the civil society that had always maintained a relationship in conflict with a government that sought corporate control, now has the opportunity to participate in the design of the country in a new relationship with government.

A strong concern still exists, however, because of the presence of certain signs threatening danger in state governments of panista extraction, such as in the cases of Jalisco, Chihuahua and New León. The panista governments in these States left a history of repression of those civil organizations that sought commitments and that criticized the government in the defense of human rights, labor: political and civic, and sought institutional answers to situations of violence. This paper supports the lowering of the profile of the Fox government.

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Contact the Author for the list of References.

New Venture Creation: Assessing Regional Entrepreneurship Potential

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Abstract

To create a positive cultural climate and structural prerequisites for entrepreneurship development, special regional characteristics should be known. A survey of entrepreneurship potential clarifies the components of entrepreneurship potential to understand the attitudinal climate and entrepreneurial readiness and a view of regional specific attributes. An untestified assumption is that there is a suitable age, something between 36-45 years, to start up a business. However, it is proposed here that there are large regional variations between certain background variables. Accordingly, it is assumed that the local entrepreneurship culture and history make it impossible to draw country-wide generalizations except with regard to, for example, family background. In this paper, entrepreneurship potential and intentions in regard to age, especially, will be analyzed. Results from three regions will be reported. The supposition of an 'entrepreneurial age', that is, a favourable age to start a business, is not valid due to local cultures and history.

Introduction

The importance of entrepreneurship in terms of regional development and even to ensure the viability of scattered settlement is nowadays more and more recognized in various countries. However, the measures promoting entrepreneurship are often random, uncoordinated, and short-sighted, that is, a central problem seems to be the incoherency, poor co-ordination, and lack of synergy of the development projects. In practice, there is a shortage of appropriation and allocation on the one hand, and a shortage of good, long-term projects on the other. In Europe, the European Social Fund tempts diverse players to apply for money for diverse and impulsive projects carried out many times, frankly said, mainly to employ the organizer and his workers. There are multiple actors contracting out development projects, due to disconnectedness of regional government, among other things, and most diverse actors are competing for development funds. Free competition as such helps to improve the quality of development activities to a certain extent, although the development activities may be less goal-oriented and less objective in their evaluation of results. There is no single right way to develop entrepreneurship. Experience and results indicate that with disconnected inputs no sustainable results can be achieved. [8] Largely, as a result of lacking entrepreneurial policy, in Finland, the proportional number of SMEs and family firms is small [9]. As economic history and statistics indicate, micro-entrepreneurship and owner-driven SME activities constitute a central balancing state of employment when volume-based production, as such certainly important, varies and causes sharp fluctuations in terms of employment. That is why more consideration of new entrepreneurship, micro-entrepreneurship, and SME activities is important.

In Finland, after the serious recession and increased unemployment in the early 1990s, the Decade of Entrepreneurship 1995 – 2005 project, a coordinated national effort to advance entrepreneurship in Finland, was established. The objective of the project was to promote entrepreneurship in a holistic and persistent way together with key interest groups. A considerably increasing proportion of entrepreneurs in the labour force, increasing new start-up activity, an increasing number of enterprises in new areas of entrepreneurship and the net increase of enterprises were some of the main objectives of the program of the project. The realisation of these objectives called for promotion of entrepreneurship in the form of new entrepreneurship, new businesses and intrapreneurship. [8]

In order to pursue a certain goal in developing society, organisations, and individuals, the prerequisite is that the starting point is known. Orientation towards goals also calls for a more accurate identification of the current situation in order to know from which starting point and in which direction to go. There are a number of assumptions, beliefs, and even 'confident knowledge' about *entrepreneurial attitudes, intentions, and prerequisites*, but in reality knowledge about these matters as well as about factual structural factors in entrepreneurship is based more on assumptions than on real knowledge. That is why a development plan for entrepreneurship, 'A new, more entrepreneurial generation', based on a starting point research on entrepreneurial potential was established. In this paper, the basic question is: Do the prerequisites of entrepreneurial development activities regionally vary? In answer to that, entrepreneurship potential and intentions in regard to age, especially, will be analyzed as an example of potential regional differences. As background information, the framework of the development pogram will be presented.

A Framework for Developing Entrepreneurship

Identification of existing entrepreneurial attitudes and entrepreneurship potential in general requires research on entrepreneurship potential. A comprehensive survey is useful in order to know the starting-points and to be able to direct and allow the measures demanded to develop entrepreneurship.

Fig. 1 summarises the logical and temporal relationship between the central elements of development of entrepreneurship as a process[i]. At its best, a survey of entrepreneurship potential clarifies the components of entrepreneurship potential (see Fig. 2 and Table 1) to understand the attitudinal climate and entrepreneurial readiness and a view of specific regional attributes. Research at macro-level should be used to examine the structural aspects of entrepreneurship so as to direct the development efforts in a proper way.

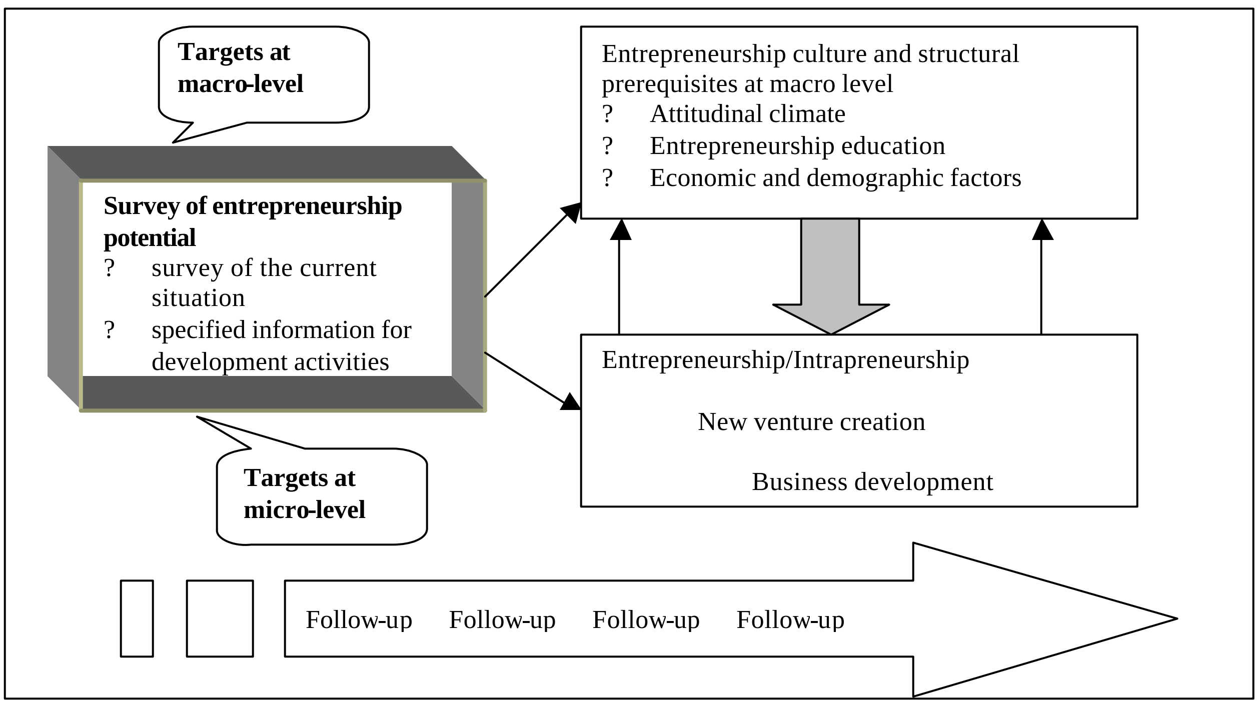

Fig. 1: THE FRAMEWORK FOR DEVELOPING A MORE ENTREPRENEURIAL GENERATION.

At micro-level, it would be appropriate to combine a survey of entrepreneurship potential with an exploration of local entrepreneurial culture, which would partly explain the background and attitudes to entrepreneurship or a wage-earner work culture.

According to the Development Plan for Entrepreneurship, *firstly*, through a survey of entrepreneurship potential, a comprehensive regional comparison base should be created to follow up the outcomes of development efforts over the next few years. *Secondly*, as an intervention this survey works as a catalyst for positive attitudes towards entrepreneurship by drawing attention to entrepreneurship as a phenomenon. *Thirdly*, informing about the results regionally provides pressure on municipal and regional government to promote entrepreneurship and its prerequisites. At its best, surveying entrepreneurship potential serves as a 'positive pressure' on development tasks. For example, if the most and least positive regions in terms of entrepreneurship can be seen on the map of a country in www, the awareness of this certainly encourages municipalities and regions to take action in various ways. *Fourthly*, it is the primary task of the survey to create knowledge about the dimensions of entrepreneurship potential as presented in Fig. 1.

Based on the dimensions of entrepreneurship potential presented in Fig. 1, regional entrepreneurship profiles, a picture of local entrepreneurship types will be gained (for example, what kind of interest, for what type of industry), to direct the development efforts to promote entrepreneurship and to make it possible to carry out better planned ‘specified development activities and training’.

Based on research results, it is possible to forecast cautiously the regional development of entrepreneurship. Positive attitudes to entrepreneurship, entrepreneurship qualities, and certain entrepreneurship identities correlate positively with entrepreneurial intentions. Entrepreneurial intentions correlate with starting up a business, although this relationship is not strong. According to pilot surveys, entrepreneurial motivation correlates quite strongly with entrepreneurial intentions.

In *regional comparisons,* research data can be examined in sub-samples according to the background variables. The different background factors can be studied in addition to general observations in terms of gender, age, education, current professional status, the industry sector, and family background. This is a way to provide focused information about entrepreneurship potential for developing attitudes, training, supporting activities, and so on.

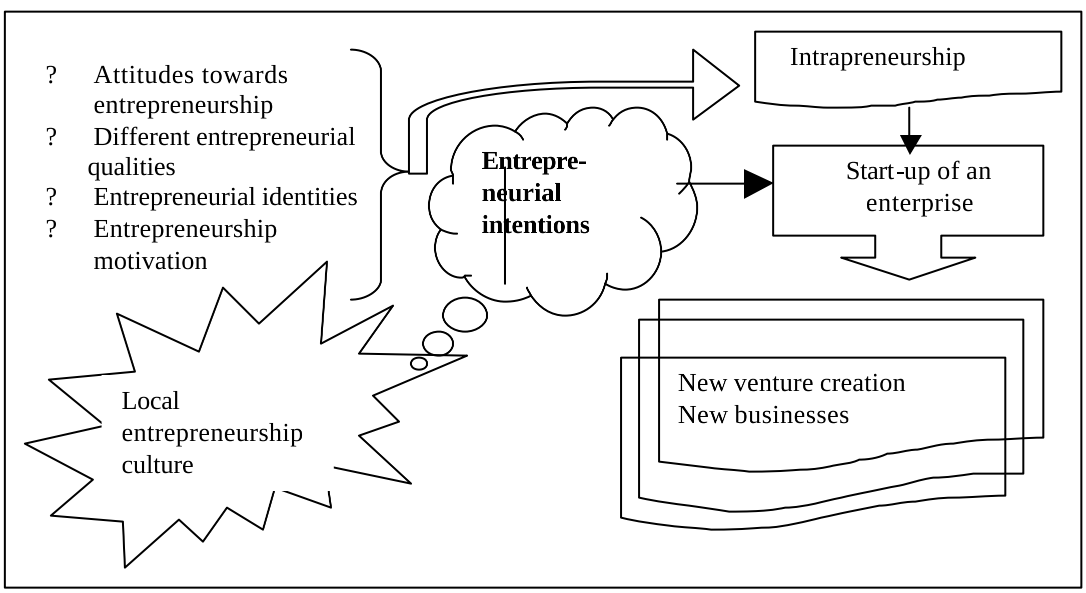

Fig. 2: THE ROLE OF ENTREPRENEURSHIP POTENTIAL IN PROMOTING INTRAPRENEURSHIP AND ENTREPRENEURSHIP.

Surveying entrepreneurship potential thus provides a broad *basic data base to understand how one becomes an entrepreneur* and how to *create preconditions* for and *reduce obstacles* to becoming an entrepreneur. Fig. 2 tries to clarify the relationship between the components of entrepreneurship potential and becoming an entrepreneur.

The local entrepreneurial culture either supports or hinders the realisation of intentions. For example, wage-earner culture and peasants' culture have a quite different effect on entrepreneurial activity in the region [1]; the former making passive, the latter stimulating.

From Potential to Intentions

It is quite a common belief that positive attitudes towards entrepreneurship should also predict the activity of new start-ups. However, for example in Finland the attitudes are very positive in general, but the number of people starting on their own in relation to the number of people of working age is lowest compared with other developed countries. Also the proportion of family firms in Finland is together with Portugal the lowest in Europe [6]. It is, however, to be noted that the phenomenon of entrepreneurial activity cannot be generalized either on a national level. The Global Entrepreneurship Monitor reports mainly country level results based on small samples giving generalizations, which have proved to be incorrect [5]. The research has discovered large regional variations and differences according to different background variables; between age groups, between male and female respondents, between family backgrounds, between groups of current professional status, etc. [3, 4, 5, 10].

Positive attitudes form the basis and favourable climate for entrepreneurship but are rarely the basic reason or motive for it. Entrepreneurship qualities may be the decisive factor when an individual is faced with the choice of an entrepreneurial career. A clear-cut entrepreneurial identity makes it easier to choose an entrepreneurial career if one is in two minds about starting up a business. However, there is a gap between 'identity' and action if the other entrepreneurial factors are not favourable. Entrepreneurial motivation is quite decisive in the case of a free choice between entrepreneur or wage earner. All these factors form a chain, which can lead to an entrepreneurial career in the context of push-and-pull factors as well as barriers to entrepreneurship. The more positive the dimensions of potential in the chain, the more probable will be the entrepreneurial career. Concerning Finland, the weakest link in the chain is entrepreneurial motivation. In Finland, the security factor is the most important motive in general [3, 4, 5]. This generally explains the weak position of entrepreneurship in Finland. This is largely due to the excessive social security in Finland and in the Nordic countries in general. Maybe also the strong uncertainty avoidance culture, typical of Finland [2] is partly behind the dominating security factor. As mentioned, there are large regional and background variations.

An untestified assumption is that there is a suitable age, something between 36-45 years, to start up a business. It is proposed here that there are large regional variations and differences between certain background variables. Accordingly, it is assumed that the local entrepreneurship culture and history make it impossible to draw country-wide generalisations except with regard to some background variables such as, for example, family background. Family background in entrepreneurial terms predicts statistically significantly entrepreneurial intentions regardless of general local cultures [3, 4, 5] It is proposed that based on the local culture, entrepreneurial potential varies in different age groups in general and between different regions. Actually, the variation is apparent also inside the regions for the same reason.

Method

To strengthen the positive attitudes towards entrepreneurship it is necessary to know the entrepreneurial attitudes of the general public. For this purpose as well as to produce knowledge for the other aims of the project, the author was authorized to construct the measure required. Accordingly, the entrepreneurship potential measure was constructed in the Department of Management at the University of Vaasa[ii]. The dimensions of entrepreneurial potential and their contents are presented in Table 1. A scale of five alternatives ranging from 'strongly disagree' to 'strongly agree' was applied when suitable. In addition to the dimensions above, offering 26 alternatives, the barriers to entrepreneurship were asked about. The potential barriers concern economic risk, entrepreneurial role, the lack of business ideas or knowledge, social risk, resources, social support, and personal traits. Further, push-and-pull factors, i.e., dissatisfaction and opportunity factors were also asked about. The question of entrepreneurial intentions consists of three dimensions, which are: the intention of starting up a firm, the intention of preparing to start one up, and the intention of being educated for an entrepreneurial career. These dimensions include several alternatives, for example starting up alone, starting up with a partner, buying a firm alone, buying a firm with a partner, etc. In this connection, starting up a firm with a company will be concerned. Of course, several background variables were asked about, too, for example, age, gender, education, work experience, current professional status, and family background in terms of the parents' occupation.

In this article, results from regions of three Employment and Economic Development Centres (EEDC) will be reported[iii]. The whole population of the North-Karelia, Häme, and Satakunta EEDC regions is 798 500, of which the target group, the relevant population representing a working age between 18 and 55 years, is less than 479 000. The final sample consists of 3 138 respondents (North-Karelia 697, Häme 1 136, and Satakunta 1 305). The response rate is irrelevant, because the sample was measured to cover at least 100 people from every rural district, which can be very small.

Table 1: THE DIMENSIONS OF ENTREPRENEURSHIP POTENTIAL.

1. Attitudes towards entrepreneurship;
Attitudes towards entrepreneurship, intrapreneurship, entrepreneurs and SMEs
2. Different entrepreneurship qualities;
Mastering one's life, tolerance of uncertainty, need for achievement, creativity, proactivity;
3. Entrepreneurial identities;
A personal interpretation about how one sees oneself as an entrepreneur; 19 response alternatives offered.
4. Entrepreneurship motivation
Challenge, self-efficacy, incentives, instrumental value;
5. Entrepreneurial intentions
A direct path to actual entrepreneurship

Results

Next, the entrepreneurial potential will be compared in the three regions, North-Karelia, Häme, and Satakunta, from the point of view of age. The aim is to find out the possible variation between the regions. Attitudes, qualities, motivation, and intentions as well as barriers are considered here. Entrepreneurial identities are not equally important from the point of view of this analysis when the probability of start-up is focused on.

As illustrated in Fig. 3, entrepreneurial attitudes follow quite similar lines in the different regions. However, the rate of attitudes somewhat varies. It can be seen that the attitudes in Satakunta are almost consistently weaker. The age group from 46 to 50 represents the most positive attitudes as well as the older people in general. The age between 26 and 30 seems also to be favourable for entrepreneurship, especially in North Karelia. In the 'start-up age' the attitudes are not particularly positive.

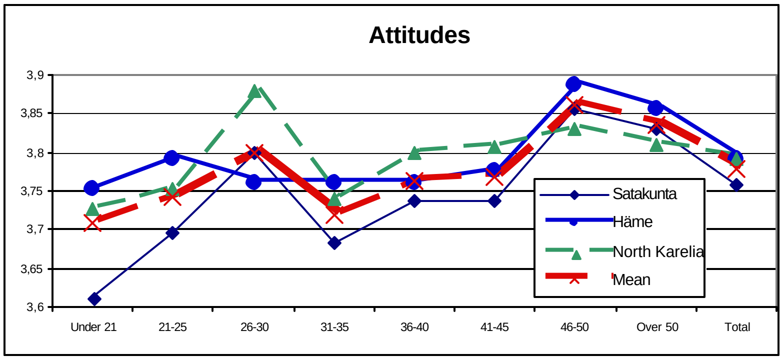

Fig. 3: ENTREPRENEURIAL ATTITUDES IN DIFFERENT AGE GROUPS.

Somewhat surprisingly, the entrepreneurial qualities seem to be at their best among the youngest people (see Fig. 4). An exception to this is Häme, where the age groups from 21 to 40 years are at quite the same level, at their highest. Compared with that, in Satakunta the level of qualities goes down with increasing age, having a small but not remarkable rise in the ages between 41 and 45 years. Correspondingly, in North-Karelia, there is a drop in ages 31 to 35. Thus the assumption of an 'entrepreneurial age' in terms of qualities is most nearly valid in Häme. To try find explanations for these regional differences, the history of the industries in these regions should be considered. In one area of North-Karelia, in Outokumpu, with an earlier active and highly profitable mine, which originated from the discovery of a deposit of copper in 1910, was closed down in 1989. It may be assumed that this setback depressed a certain generation, especially the age group of between 31 and 35. They experienced a too long period of local unemployment and pessimism. On the other hand, Pori, and Rauma, the main towns in the Satakunta region, have a quite thriving industrial history in terms of heavy industry and as ports. From father to son, the inhabitants of those areas were employed in that industry. The last twenty years have, however, shown a decline. It may be mentioned that the empty apartment houses of earlier industry workers owned by the employing industry in the harbour of Pori are a terrifying reminder of bygone times of industrial wage-earner culture. The region and its towns have built their future on the pillars of heavy industry, neglecting the importance of entrepreneurship and entrepreneurship education. Now the industrial towns are taken by surprise, trying to build a new culture.

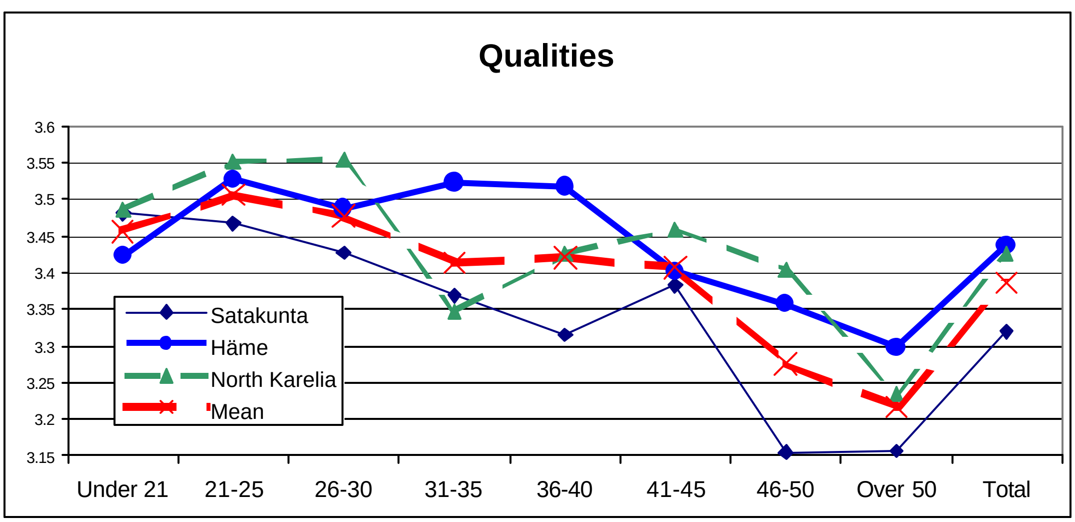

Fig. 4: ENTREPRENEURIAL QUALITIES IN DIFFERENT AGE GROUPS.

Just the other way round, entrepreneurship motivation increases with the age, except for those between 26 and 35 in North-Karelia (see Fig. 4). In Häme, the age group of 31 to 35 shows the highest motivation, and the older groups are also quite motivated. In North-Karelia also those of 36 and upwards are most motivated as regards entrepreneurship. In Satakunta, the peak is at the ages of 46 to 50. In North-Karelia, the motivation goes along the same line as attitudes and qualities, i.e., the frustration of that generation is pervading all the elements of entrepreneurship potential. In Satakunta, the trend is also in accordance with the other dimensions of entrepreneurship potential.

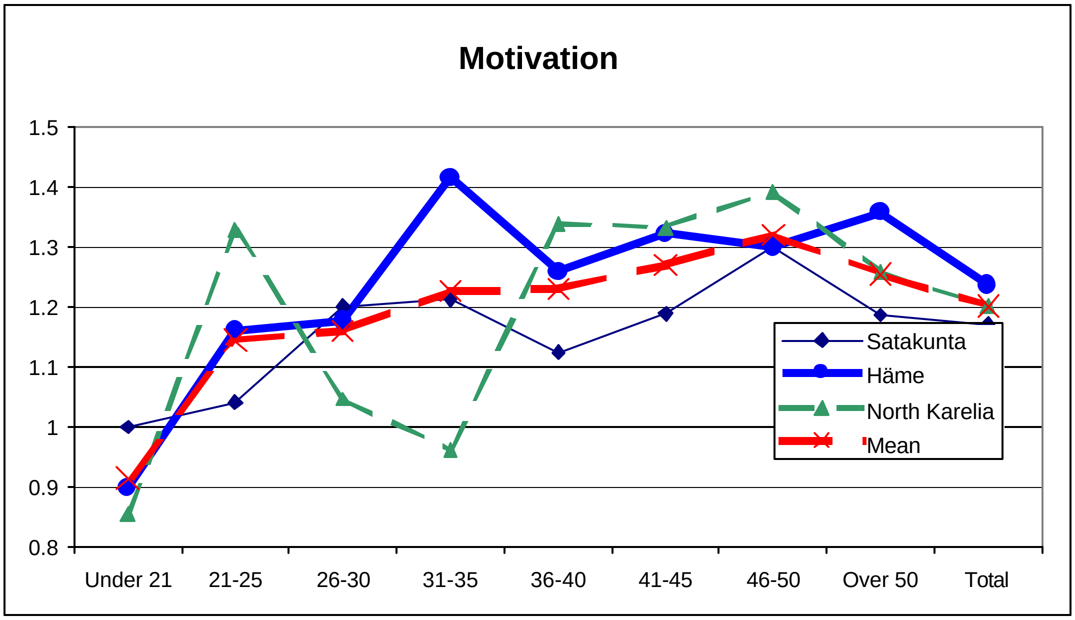

Fig. 5: ENTREPRENEURIAL MOTIVATION IN DIFFERENT AGE GROUPS.

Taking a look at the barriers to entrepreneurship, one will find that in North-Karelia those with the lowest entrepreneurship potential meet the highest barriers to entrepreneurship. In Satakunta, correspondingly, those in the entrepreneurial age of 31 to 45 meet higher barriers than respondents on the average. Consistently, respondents in Häme who have the greatest entrepreneurship potential also find the lowest level of barriers.

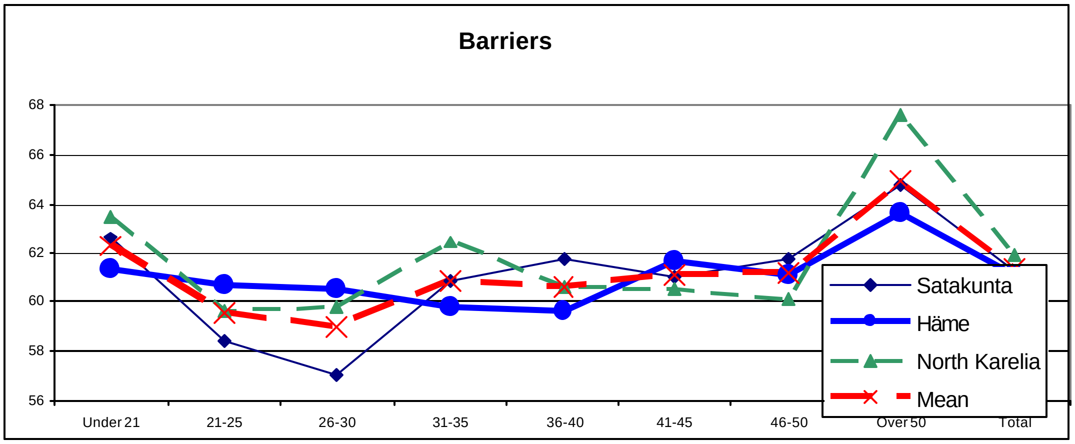

Fig. 6: BARRIERS TO ENTREPRENEURSHIP MOTIVATION IN DIFFERENT AGE GROUPS.

From the point of view of new venture creation, intention is the most important step before start-up. Who are those starting up? As mentioned, those coming from entrepreneurial families are most probably starting up [3, 4, 5] but what is the role of entrepreneurship potential as regards age? As could be supposed, in Häme those between 31 and 45 are the most probable starters (see Fig. 7). However, at the age of 36 to 40 there seems to be a drop in all of the regions. It may be a phase in the human life cycle where career and family are clashing in a way that forms a barrier to entrepreneurship to some extent. Concerning North-Karelia, it could be expected that those of the ages of 26 to 30 have not a very high rate of intention, in spite of the most positive rate of attitudes in the region. That is, the level of attitudes is not a reliable predictor of start-ups. In accordance with the entrepreneurial potential reported, the rate of intention decreases in Satakunta after the age of 26 to 30. Those in the 'entrepreneurial age' are not most active as regards intentions. In Häme, again according to the coherent entrepreneurial potential, a favourable age to start up is between 31 and 50, excluding the small drop at the age of 36-40. Additionally, in Häme, the youngest group seems to have a relative abundance of intentions, too.

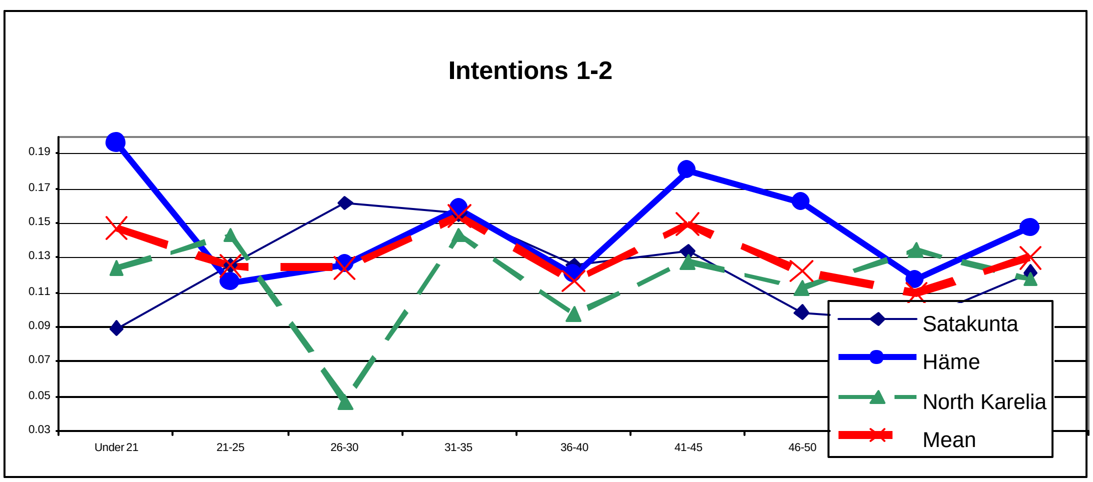

Fig. 7: ENTREPRENEURIAL INTENTIONS IN DIFFERENT AGE GROUPS.

Conclusion

Based on the results obtained above, it can be concluded that entrepreneurship potential and intentions walk hand in hand. Further, it can be stated that they cannot be generalized on a national level, not even on a regional level due to the large regional variations and differences between certain background variables. As regards age, the supposition of an ‘entrepreneurial age’, that is, a favourable age to start a business, is not valid due to local cultures and history. As reported above, in one region, the age cycle behaved as expected; the most favourable period of starting up was found to lie between 35 to 45, or even 50, years. However, in another region a temporary setback seems to have ruined a certain age phase, especially the ages between 31 to 35. Further, a third of the regions concerned had experienced a long period of decline which, as assumed here, caused damage to the entrepreneurship potential of several generations. In this region, only the youngest generation, grown up after the period of decline, during the new orientation phase of the region, showed some entrepreneurship potential.

Accordingly, there are few explanatory factors which can be generalized above regional or local cultural and structural circumstances. A careful analysis and comparison of several potential and background variables inside and between regions should be performed in order to get more exact knowledge for promoting entrepreneurship and new venture creation. In order to promote regional and local entrepreneurship, a careful survey of entrepreneurship potential, preferably accompanied by an exploration of local culture, should be made. Entrepreneurship development requires, first of all, intrapreneurship of the actors, and understanding of entrepreneurship in terms of theoretical as well as of practical points of view. That is why public bureaucracy is not capable of managing entrepreneurial development [9]. For example, the number of SMEs has turned to decrease.

References

Contact the author for a list of references.

End Notes

[i] For more details, see http://www.uwasa.fi/ktt/johtaminen/index2_e.htm]

[ii] Especially by Drs T. Pihkala and J. Vesalainen (a pilot study, see Vesalainen/Pihkala 1998).

[iii] See also Routamaa, V. (2001). Laying the Foundation for New Venture Creation: Assessing Regional Entrepreneurship Potential. In A. Miettinen & H. Klandt (Eds.) FGF Entrepreneurship-Research Monographien. Band 25. Josef Eul verlag GmbH: Lohmar, Germany.

Family Firms in Western Mexico: Regional Profiles Facing Global Challenges

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Abstract

Based on previously reported instruments, an instrument has been developed to assess family firm profiles, in terms of family dynamics and resources, and in terms of managerial skills and competitiveness in open markets. This instrument has been applied to a sample of family firms in several cities in Western Mexico.

Results show the complexity with which family and business issues are intertwined in these firms. However, clear patterns emerge when specific interactions between system components are mapped with the aid of this instrument. Specifically, as identified by several authors in the field, three subsystems are closely scrutinized: family, business and property. Implications for both management and policy issues are discussed. Most of all, specific attention is given to the identification of sources of stress for both business and family structures. Criteria for their evaluation and management are also set forth.

Introduction

Even though few reliable statistics are available, family firms in Latin America seem to have a stronger relative importance in their economies [Poza, Danco and Nader 1998, De la Cerda 1995] than in industrialized countries. It was only as late as the middle fifties that Mexico started its industrialization process. Many firms were first created in the following two decades, mostly by entrepreneurs with little formal education, and without a strong industrial culture to back them. In a significant proportion of those firms that survive, founders are currently at their final stage of their entrepreneurial careers. Their firms are therefore facing the crises and challenges that come with succession issues.

On the other hand, the opening process for the nation's economy started in the middle eighties, and acquired a much significant momentum in 1994, with NAFTA. Having developed within an export substitution industrial policy, which secured closed markets for them, firms developed an entrepreneurial and managerial culture that is not well prepared to face the challenges of international competition. On top of this, for historical and geographical reasons, entrepreneurs in Western Mexico are wary of problems that come with growth and size in their firms. Their survival strategies in recurrent economic crises in the last decades have depended on the agility of their firms to adapt to small market niches [Nunez y De la Cerda 1993]. To a large extent, survival strategies in Western Mexico meant keeping firms' size small, and relying to a large extent in informal networks to provide alternative income sources and to manage human resources as through flexible structures [Calleja 1994]. Among those networks, as is usually recognized for Latin American countries because of their culture, the family is of prime importance [Young and Welsch 1993].

All of these factors, which are present to varying degrees in different industrial sectors [Arechavala 1998, 1996]; currently lead family firms to face significant challenges. In a significant proportion of firms, succession is an open issue, while international competition places previously unknown challenges to them. To the extent that succession planning is not yet a common practice in the region, the associated risks and crises are becoming common for these firms. Which are the most salient characteristics of typical family firms in Western Mexico? How do they affect their capacity to face those challenges that come with international competition? How do family dynamics and resources affect their competitiveness? What influence do business factors have in family interaction patterns?

The family system, the business system, and the interaction between them.

Research on family firms has explored different processes and has focused in different aspects of a family firm. Family businesses are closely related to entrepreneurial behavior, they give rise to gender, governance, and succession issues; the firm's performance profoundly shapes family dynamics, and it is determined itself by the ability to tap on the family's emotional and professional resources and skills. It is therefore inherently difficult to develop a model of all those factors and processes that can cut across disciplines.

Models developed so far concentrate mostly on one or a few of these aspects of family firms. A few of them focus on the interface between family and business, and the way in which it shapes their interaction. It should be clear, however that these two domains interact in ways that either facilitate or hinder important capacities for both the family and the firm.

Starting from the view that the family's profile is shaped by factors that are common to other groups, Danes, Rueter, Kwon and Doherty [2002] adapted a model of how interactions among family members and business decisions and goals are integrated. Their model is based on the Family FIRO model developed by Doherty and Colangelo [1984] which itself is an application of a model developed for groups. Based on the explicit recognition that "family and business goals are forces that steer each family business through predictable patterns of growth and change", they explore the processes that determine the family's ability to integrate those factors that influence "the well-being of the whole system and the achievement of goals" [Danes, Rueter, Kwon and Doherthy 2002, p. 33].

As discussed by Riordan and Riordan [1993], it is not correct to conceive family and business systems as systems that should operate independently of each other. As owners/managers painfully know, "(…) owner-managers are expected to direct behaviors simultaneously to achieve both family and business goals. It is impossible for the majority of individuals to excise the business 'system' from the context of the family and business" [Riordan and Riordan 1993, p. 67]. Actually, our group's experience and field research direct us to concur with their view that: "Control approaches that focus on the business as a separate system ignore the ability of the owner-manager to allocate resources in non economic ways to fulfill personal family goals. Advice to excise business decisions from family interference ignores reality." [Riordan and Riordan 1993, p. 76].

Advocating a field theory model of family and business interactions, Miller, Fitzgerald, winter, Paul and Kaye [1999] state that "The system requirement to establish consistent, clear boundaries between family and business systems is not always possible. Sometimes the problem at hand cannot be cleanly placed in the appropriate system. Business conflicts arise that spill over to affect the family and vice versa." [Miller, Fitzgerald, Winter, Paul and Kaye 1999, p. 254] Field theory has the ability to overcome this limitation while holding that "The central tenet of field theory is that individuals hold positions within a field or life space and attempt to maintain a dynamic equilibrium in relation to their environments (Deutsch,1954)" [Miller, Fitzgerald, Winter, Paul and Kaye,1999, p.254]. In their view, this fact has implications for both the family and the business's health:

"Because conflict occurs frequently within a family business, it is important to identify the source of conflict. Given the limitations of the overlapping family and business fields, it is also important to try to manage each component effectively for the adaptation and survival of both the family and the business" [Miller, Fitzgerald, Winter, Paul and Kaye 1999, p.255].

According to Riordan and Riordan's perspective, "(…) family business managers attempt to reach business and family goals simultaneously, thus, attempting equilibrium in both the business and the family fields" [Miller, Fitzgerald, Winter, Paul and Kaye 1999, p.254].

Individuals make decisions that simultaneously include influences from all of the groups to which they belong. They are subjected simultaneously to several influences. "Individuals make decisions in a life space that includes **simultaneously all of the groups with which they are interdependent**" [Riordan and Riordan 1993, p. 76] (emphasis added).

The potential for conflict to spill over from one domain to the other is unavoidable. "In family firms, work-related roles affect family roles and vice versa (…) Consequently, behavior-based internal conflict is regarded as being particularly ubiquitous and unavoidable among members of family firms (…) Behavior-based interrole conflict involves discord associated with behavioral expectations across roles (e. g. owner vs. parent). Differences between family and business cultures also contribute to interrole conflict." [Smyrnios, Romano, Tanewski, Karofsky, Millen and Yilmaz 2003, p. 38]

Looking at the same issue positively, one of the models that look closely at this interface has been developed by Habbershon and his group, within their resource-based view (RBV) of the firm. Tenets of this framework for assessing strategic advantages of family firms are based on the recognition that family firms can have important advantages, the origin of which lies within the owner families and their relationship with the enterprise. "The RBV of competitive advantage, because it examines the links between a firm's internal characteristics and performance, provides the opportunity to more fully delineate the competitive capabilities of family companies (…) In contrast to the generic approach, specific family firm resources are identified and matched to the firm's capabilities. (…) 'Familiness' is defined as the unique bundle of resources a particular firm has because of the systems interaction between the family, its individual members, and the business." [Habbershon, Williams and Kaye, 1999, p.6-7]

But, should the family be considered only as potential resources to be applied to the business, or does it have developmental goals of its own, that should be at least well taken care of? At least in the Mexican culture, this is not only the case, but it is also the case that individuals are expected to find in the family a nurturing context, conducive to their own development and growth as individuals.

Is this context, and its implicit goals, affected by patterns of interaction in the business? Again, as owner/managers painfully know, and as is consistently reported by consultants, it is. Even though systematic research has not addressed this phenomenon directly or consistently, business problems are usually carried into the family context, and they either create or feedback into interpersonal conflicts in the family.

Thus, the model for this study is built under the assumption that not only family interaction patterns influence the business system performance, **but that personal interaction patterns in the business system affect family capabilities and performance.** Underlying this assumption is also the tenet that a family is a system that has growth and performance capabilities. Just as the business system is expected to generate wealth and perform successfully in several dimensions, **the family should foster the growth and well-being of its members and of the family as such.** Family capabilities are affected by business interaction patterns and performance, and these capabilities can also be assessed.

This view of the family/business system is consistent with the Sustainable Family Systems Model proposed by Stafford, Duncan, Dane, Winter, and Kaye [1999], which states that "(…) sustainability of the family business (is a) function of family achievements and business achievements and transactions between the family and the business (…) families must be as efficient in the pursuit of satisfaction as a firm must be in the pursuit of profit", [p. 202]. Their model "(…) includes analogous processes in the family and the business systems (but) separates them to call attention to the difference in purpose and specific content of the processes within the two systems." [p. 202]. Furthermore, it proposes that the study of interaction patterns should acknowledge that business and family interactions may change during times of environmental change, structural change, or both. "Sustainability results from the confluence of family success, business success, and appropriate response to disruptions (…) Sustainability also requires consideration of the ability of the family and business to cooperate in responding to disruptions in a way that does not impede the success of each." [p. 203].

The Instrument

To this date, there is little empirical research on family firms in Mexico, reported in the scientific literature. Our study, therefore, is to a large extent exploratory. Even though it is likely that many phenomena studied elsewhere would also occur in our context, we do not know yet to what extent cultural characteristics in Mexico would imply significant changes in the applicable models.

Based on the models mentioned in the previous section, and on a review of both the academic and the consulting practitioner's literature, we developed a conceptual model of those areas of family firm member interaction that have a significant potential to influence both the family and the business systems. This instrument is designed to both in terms of family dynamics and resources, and in terms of managerial skills and competitiveness in open markets.

The underlying rationale is that, just as the "Family FIRO Model" [Danes, Rueter, Kwon and Doherthy, 2002] implies, patterns of member interaction determine the family's ability to achieve its goals. Identity and control issues determine the way and the degree in which they can integrate both family and business resources to achieve common goals. From the practitioner consultant literature, we have identified the following fields of interaction that reflect control structures that can significantly affect performance in both the family and the business systems. The instrument includes several items for the assessment of patterns of interaction in each one of several areas. As proposed by Stafford, Duncan, Dane, Winter, and Kaye [1999], it also includes items that attempt to measure the ability of the family and the business to adapt their interaction patterns to respond to change in environmental conditions, as well as in structural conditions, both in the family and in the business system. The following are the areas in which the instrument attempts to measure interaction patterns, as reported by the owner/manager:

Commitment:	The family and its members' commitment to the sustainability of the firm beyond the generation of the founder.
Training:	The norms that govern the ways in which family members are trained for jobs in the firm.
Succession planning:	Family member knowledge of, and eventually participation in, succession plans.
Interpersonal dynamics:	Openness, communication, and conflict management, as is reflected both in the business and in the family system.
Gender issues:	Family attitudes and values around equality and opportunities for both genders in the firm
Property management:	Rules and values in assigning property of the firm to family members.
Management skills:	Reported behavior in the development of management skills in family members, and the assignment of jobs and responsibilities in the firm to them.
Fairness:	Rules and values in evaluating performance and assigning compensation, promotion, and incentives to family members and non-family members in the firm.
Patrimony management:	Reported behavior in managing family financial resources, business resources, and the flow between them.
Performance evaluation:	Definition and communication of performance evaluation criteria for family vs. non family members.

Items in the questionnaire describe desirable interaction patterns in each of these areas. Responses, on a Likert-type scale, indicated the degree to which those descriptions are applicable to the family firm.

Patterns of interaction in the domains outlined above affect performance of both the family system and the firm system. Interaction patterns described in each of the questionnaire items will affect one or more of the family and the business capabilities. Based on research literature, on practitioner consultants' literature, and on previous fieldwork, these interaction patterns' effect on several systems' capacities were assessed:

Business System	Family System
Growth: The capacity of the firm to constantly increase its patrimonial value and its return on investment.	**Family harmony**: Patterns of interaction among family members that foster inclusion, trust, individual and collective well-being and growth.
Institutionalization: Its capacity to endure as an organization, regardless of whether the persons in charge are members of the family or not, and regardless of who controls ownership of the firm.	**Communication**: the presence and consistent use of communication channels and mechanisms in the family.
Sustainability: The capacity of the firm to mobilize and capture resources in favor of its development and competitiveness.	**Conflict resolution**: Ability to face and solve conflicts within the family, when they appear.
Results: the capacity of the firm for consistently generating positive business outcomes.	**Growth/nurture**: ability of the family to prevail as an environment that is conducive for members' well being and personal growth.
Managerial capacity: the ability to consistently develop higher managerial talent in the firm.	**Involvement**: Degree of commitment in family members to maintain the viability of the firm as a family enterprise.
Innovation: The capacity of the firm to adapt to changing conditions, and to keep abreast of the competition.	**Foresight**: Ability of the family to foresee contingencies that may endanger the family-business system, and to plan for them.

A score for each participating family firm was derived for each one of these capabilities. Scores are computed as the percentage of the desirable interaction patterns that are present, and the degree to which they are present in each case.

Methodology

The instrument is administered in an interview with the owner/manager of the firm. Interviews were 60 to 90 minutes in duration, on average. The first part of the interview deals with the history of the firm and of participation of the family in it. This part of the interview helps in assessing the validity and reliability of the instrument. A second part was dedicated to gathering data about the business's organizational structure, participation of family members in that structure, and in its ownership. The third part consisted of administration of the 74-item questionnaire by the interviewer.

A report is presented to owner/managers, with an assessment of what the instrument indicated about their businesses' and about their families' capabilities, as affected by the interaction patterns reported by them. The validity of those assessments and their implications were discussed with them in every case. Although its foundations are built on theoretical models reported in the literature, this phase of the study has not been directed towards hypothesis testing. The aim of the study has been mainly to validate the instrument, and to begin to draw the typical profiles of family businesses in the central and western part of the country.

The issue of sampling has several aspects to consider. One of them is the theoretical interest of the study, but the other is the availability of access to the firms, in order to obtain their consent to participate in the study. Rather than assuming a strict definition of family firm, from which a decision rule of whether a firm was a family firm or not would follow, we assumed Astrachan's approach [Astrachan J.H., Klein S.B., and Smyrnios K.X. , 2002] in which the question is rather the degree to which a family holds control of the firm.

However, given the objectives of the study, it was important to identify family firms that could be expected to at least attempt to maintain the integration of both the family and the business systems. Therefore, an important criterion for sampling was that they would show a clear determination to maintain the viability and control of the firm for future generations in the family.

Because of cultural values, firms are reluctant to provide information to strangers. In most cases, however, it is enough that the researcher be introduced to the owner/manager by a trusted third party. Random sampling is therefore out of the question. Researchers from our group initiated network cascading techniques in order to obtain access to, and participation of, firms in the study. At this time, the sample consists of 39 cases.

Contrary to the general expectation that family firms are mostly small businesses, firms participating in the study were not selected for size. Even though in Mexico it is customary to differentiate four levels, according to size (in number of workers and sales), this differentiation is not essential to the objectives of the study. Moreover, since the main goal of the study implies that interaction and viability of the family and the business be considered in the long range, it is to be expected that successful family firms would grow as successive generations are in charge, and should therefore be included.

Results

One out of 40 cases had to be eliminated from the sample, because related items in the questionnaire indicated that the family was not interested in continuing with the firm, even though it had interesting characteristics and performance indicators. Furthermore, the accompanying history, revealed that they were about to sell it. Final size of the sample was 39, with the following characteristics:

TABLE 1. BUSINESS CHARACTERISTICS

	n	**Percentage**		**n**	**Percentage**
Size of firms			**Longevity of firms**		
Small and medium	37	95%	1 - 10 years	3	8%
Large (>200 employees)	2	5%	11 - 20 years	12	31%
Sector			21 - 30 years	11	28%
Industry	23	58%	31 - 40 years	5	13%
Commerce	8	21%	41 – 50 years	2	5%
Service	8	21%	51 – 65 years	6	15%
Line of business			Mean of longevity	27.64	
Leather and shoe industry	6	15%	**Generation managing**		
Metal-mechanic	6	15.%	First generation	28	76%
Confection and textile	4	10.%	Second generation	10	22%
Food industry	6	15%	Third generation	1	2%
Graphic Arts	3	8%	**Exportation**		
Commerce	8	21%	Yes	8	20%
Others	6	16%	No	31	80%

TABLE 2. FOUNDER'S AND MANAGERS' CHARACTERISTICS

	n	Percentage		n	Percentage
Average age of founders			**Average of managers**		
30 – 40 years	4	14%	30 – 40 years	10	26%
41 – 50 years	5	18%	41 – 50 years	11	28%
51 – 60 years	10	36%	51 – 60 years	13	33%
61 – 76 years	9	32%	61 – 70 years	5	13%
Mean age of founders	55.82		Mean of age managers	48.72	
Gender of founder			**Gender of managers**		
Male	34	87%	Male	33	85%
Female	5	13%	Female	6	15%
Education founders			**Education managers**		
No formal studies	3	8%	No formal studies	0	0%
Basic studies	8	21%	Basic studies	3	8%
Medium studies	15	38%	Medium studies	15	38%
University studies	9	23%	University studies	16	41%
Master degree	4	10%	Master degree	5	13%

Tests for inter-item correlation showed absolute values between 0 and .75. Only one of them reached the value of .798.

Average scores for family and business capabilities, as described above, are shown in table 3.

TABLE 3. BUSINESS CAPABILITIES AND FAMILY CAPABILITIES.

BUSINESS CAPABILITIES	MEAN	SD		FAMILY CAPABILITIES	MEAN	SD
Growth	0.56	0.11		Family harmony	0.67	0.11
Institutionalization	0.60	0.13		Communication	0.65	0.13
Sustainability	0.61	0.12		Conflict resolution	0.65	0.11
Results	0.62	0.13		Growth/nurture	0.58	0.10
Managerial capacity	0.63	0.14		Involvement	0.72	0.12
Innovation	0.56	0.14		Foresight	0.61	0.19
Overall business score	**0.60**	**0.11**		**Overall family score**	**0.65**	**0.11**

It may be noticed that average scores in business capacities are generally lower than family capacity scores. This is reflected in the overall mean score for both domains. A rather interesting finding is that family firms that score well in business capabilities also tend to score high on family capabilities (Pearson r=.904)

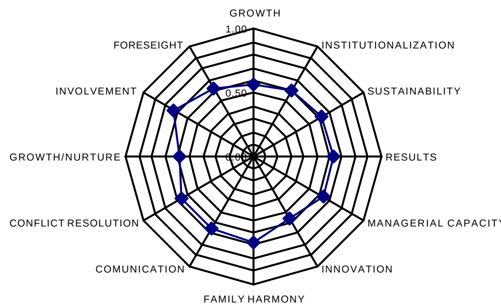

FIG. 1: GRAPHIC REPRESENTATION OF AVERAGE BUSINESS AND FAMILY CAPACITIES IN SAMPLE.

Preliminary results show the complexity with which family and business issues are intertwined in these firms. However, clear patterns emerge when specific interactions between system components are mapped with the aid of this instrument. Specifically, as identified by several authors in the field, three subsystems are closely scrutinized: family, business and property [Gersick, K., Lansberg, I., Desjardins, M., and Dunn, B., 1999].

In the regional context, common pattems begin to emerge with regards to the ways in which family firms are coping with current challenges, and with regards to those competencies that they must address directly, if they intend to survive in the currently turbulent environments they face.

Self-reported assessment of interaction patterns relating to various family and business issues show strong associations among them. These associations develop into a complex network of relationships among patterns of interaction which could initially be considered to have little to do with one another. While it is not surprising that association in responses to items from the same area or field of interaction (as detailed above) show strong correlations[i] among them, it is interesting to find that patterns of association between responses to different items consistently cross among areas. Pending the development of a more sophisticated model, as more cases become available, we have found the following major correlations among items pertaining to different areas in the instrument[ii]: A few examples are the following:

TABLE 4: SELECTED ITEM INTERCORRELATIONS.

Item	**Pearson r**	**Item**
The way in which the succession process should take place when the moment arrives is clear for me.	.70	We have clear rules for the participation of family members in the business, and they are well known by them.
Family conflicts do not affect business performance.	.55	Family patrimony is handled separately from the business's capital.
(It is not the case that) Some family members do not live up to expectations in their performance.	.55	Those family members with a greater motivation and capacity have a greater share of property in the business.
Each member's contribution to family harmony is clear and valued by the others.	.55	Only family members who wish to work in the business.

Association among responses to different items tends to group them in distinct sets, mostly according to interaction patterns that belong to the same area. More interesting is the fact that responses to items dealing with the succession process have a strong association with multiple interaction patterns and capabilities in both family and business arenas. Of particular notice is the fact that succession process items are strongly associated to items pertaining to performance evaluation, commitment of family to business, interpersonal dynamics, and management capacity.

Discussion

Relatively high scores for family system capabilities, although not surprising in the Mexican cultural context, have been paid relatively little attention in the family business literature. Even though our sample is still small, it may be assumed that the instrument captures important aspects of the family business system in this regard. Whether this result may hold in different cultural contexts is still to be seen. Cross-cultural research, with all its logistic and methodological problems (see Birley 2001) will provide a much better frame of reference to assess its real value.

Strong association among interaction patterns that would seemingly pertain to different domains (like patrimony management and interpersonal dynamics, or property and performance evaluation, for example) point in the direction of very close connections among interaction patterns and capabilities both in the family and in the business system. As field theory applied to the family business context implies, the behavior of individuals in the system do not only respond to values and interests in one group or the other. Over and above that, however, some of the interaction patterns developed in the family and in the business tend to be strongly associated with others pertaining to different functions in them. Assessing the relative integrity and performance of each subsystem, therefore, cannot easily be done disregarding the other.

This point stands out when considering the degree of association between items related to succession process and items related to interaction patterns in performance evaluation, interpersonal dynamics or management capacity, for example. Analyzing individually and collectively those items that show a strong association with succession issues, we interpret the observed patterns to mean that the succession process is a complex one, which demands that the family and the business bring their resources and capabilities fully into play. Family's commitment to the business, interpersonal dynamics, performance evaluation and management capacities are among the ones whose support is demanded most by requirements of the succession process.

The fact that there is a strong correlation between overall scores in family and business capabilities further strengthens one of our main arguments: that effects of interaction patterns in both accounts cross over into each other. Validation of these interpretations is provided by accounts of the business and the family histories that are documented during the interviews. We are perfectly aware, however, that this strong correlation is not entirely (and maybe not even principally) due to empirical correlations among independent variables. A significant portion of it is likely due to the way in which interaction patterns are considered to affect different family and business capacities. Interesting conceptual and structural features of the implicit model need to be sorted out.

To the degree that our instrument is based, to a large degree, on the application that Danes, Rueter, Kwon and Doherthy [2002] develop of the Family FIRO model to family businesses, the mentioned high correlations in both family and business interaction patterns implies that this model can in fact be applied to predict performance in both arenas. This conclusion also reinforces the resource view of the family firm that Habbershon and his group advocate.

What this implies, in a more general vein, is that families who can be considered as groups with greater resources and better patterns of interaction will be more successful in family and business arenas at the same time. The degree to which this may be the result of better integration patterns and skills (as in the Family FIRO model), the result of better education, or of other variables, will be an interesting matter to explore in future research.

Implications for both management and policy issues

Recognition of the strong interdependence between the family and the business system should help both owner/managers and policy makers in understanding that sources of stress in one of them will necessarily impact the other. As policy makers realize that when family businesses are unable to follow through into successive generations a valuable business know-how and social capital are lost, measures directed to the training and support of family business members could be devised. Small businesses, which usually are family businesses, can be better helped as the strong interactions between the two subsystems are understood.

As Mexico's current policy is the promotion of the establishment of small firms, it is important to realize the ways in which informal and family networks enable young entrepreneurs to initiate and carry on their projects. Even though reliable figures are not available, however, it is estimated that 50% of small firms existing at any one time will not survive beyond two years. As they grow into more mature businesses and approach succession stages, another set of perils await them. Knowing more about how to identify enabling (rather than disabling) interaction patterns is important. Knowing more about how family and business interaction patterns feedback into each other may help devise programs that can help more in their successive developmental stages.

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End Notes

i Even though our data do not strictly represent continuous normally-distributed variables, and therefore the use of Pearson correlation should be questioned, non-parametric tests have proven also to show the same strong associations among them. We have chosen anyway to use this index in this presentation in order to emphasize the fact that association among the variables is strong enough to warrant further exploration.

ii Due to space limitations, only those correlations that are most meaningful in the regional entrepreneurial culture are reported.

Issues and Research Agenda for Malaysian SMEs Revisited

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Abstract

Small and medium-sized enterprises (SMEs) represent an important part of the Malaysian business system. Notwithstanding their economic importance, research on SMEs is still limited and neglected. The literature review indicates SMEs in Malaysia have attracted minimal theoretical as well as empirical research attention from researchers as a field of study. Based on the review of the small business literature, this paper initiates an attempt to provide a research agenda for studying SMEs in Malaysia - stressing the shortcomings of past studies as well as highlighting the major issues and research areas that have yet to be explored and benefited by future researchers.

Introduction

In Malaysia, despite their significant role in the national economy, research on SMEs appears limited and neglected. The literature indicates that SMEs have received minimal theoretical and empirical research attention as a serious field of study. Recent reviews have revealed this important issue as well as indicated the gaps in our knowledge concerning SMEs in Malaysia.

A basic conclusion of the reviews has been that previous studies are exposed to several limitations and as such do not seem to have been able to provide a framework for better understanding of the sector. Given the various shortcomings of past studies, the major issues and research areas pertaining to SMEs, it is high time for us to develop a new research agenda for SMEs in the Malaysian context. Attempting to meet this need, this paper aims at spearheading the development of serious research tradition for SMEs in Malaysia.

The present paper is divided into five sections. Sections Two and Three focus on the basic issues which needed to be addressed before proper research on SMEs could be conducted. Following this, Section Four highlights the limitations of the previous works on SMEs in Malaysia. Based on the findings in these sections, a research agenda is proposed in Section Five. Finally, Section Six presents the concluding remarks for the paper.

Research Issues Concerning SMEs in Malaysia

Issues concerning the concept of SMEs

As far as the concept of SMEs is concerned in Malaysia, the author identified two major issues that need to be clarified not only by researchers but also policy makers. The two conceptual issues are discussed briefly below:

SMEs or SMIs?

In Malaysia, the terms small and medium-sized enterprises (**SMEs**) and small and medium scale industries (**SMIs**) are often used interchangeably to mean the same thing. However, it is important to note that the two terms does not mean the same thing. In economics, an industry means a group of firms producing the same type of products. Whereas, an enterpris*e* refers to a firm (which can be small, medium or large) in an industry. This means that enterprises of various sizes are found in an industry. Hence, it is the enterprise that is small-sized or medium-sized, and not the industry. As such, "enterprises" (and not "industries") is the accurate and appropriate term to be used. Accordingly, the acronym SMEs (and not SMIs) is used throughout the present paper. By doing so, the authors hope to avoid confusion because SMEs can be found in almost all industries.

Inappropriate definitions of SMEs

There are not less than 18 ministries and more than 60 government agencies involved in assisting the development of the SMEs sector in Malaysia (Hashim, 2000). However, these agencies used different criteria to classify SMEs. In other words, the term SMEs still appears to have been differently defined by the various supporting agencies.

On behalf of the Division of Small Enterprise in the Ministry of Trade and Industry, the Coordinating Council for Development of Small-scale Industries (CCDSI) offered one of the earliest formal definition of SMEs in Malaysia. Initially, the CCDSI defined SMEs as enterprises with fixed assets of less than RM250,000 or; in the case of companies, the shareholders' funds not exceeding RM250,000.

Subsequently, in the Industrial Coordination Act 1975 (Amendment 1986), the Promotion of Investments Act 1986, and as noted in the Bank Negara's lending guidelines, SMEs are defined as enterprises with net assets or shareholders' funds of not more than RM2.5 million (see Malaysia, 1998). Under this definition, a firm with shareholders' funds of less than RM500,000 is considered as small, whereas a firm with shareholders' funds of between RM500,000 to RM2.5 million is labeled as medium-sized.

Another of the earlier definition of SMEs in the country was also provided by the former Small-scale Industry Division of the Ministry of International Trade and Industry. According to this definition, an enterprise with assets or shareholders' funds between RM500,000 to RM2.5 million and employs full time employees of between 5 to 10, is an SME.

In 1995, the Small and Medium-sized Industry Development Corporation (SMIDEC), which replaced the former Small-scale Industry Division in the Ministry of International Trade and Industry defined SMEs as:

a. Small-sized business enterprise is "an enterprise with a paid-up capital of less than RM500,000 and employs full time employees not exceeding 50 persons";
b. Medium-sized business is "an enterprise with a paid-up capital of RM500,001 to RM2.5 million and employs full time employees of between 51 to 75 persons".

More recently (as reported in the New Straits Times of January 19, 1998), realising the inappropriateness of its old definitions, the Ministry of International Trade and Industry reclassified SMEs in the manufacturing sector as:

a. A small-scale firm is a company "with less than 50 full time employees, and with an annual turnover of not more than RM10 million".
b. A medium-scale enterprise is a company "with between 51 and 150 employees, and with an annual turnover of between RM10 million and RM25 million".

In short, definitions of SMEs in Malaysia are not uniform and that they are too general in nature. Moreover, these definitions are based on fixed quantitative criteria only, making their operational value questionable (Hashim and Abdullah, 2000).

Data sources for research on SMEs

The used of various definitions of SMEs in Malaysia could be attributed to the difficulties in obtaining the accurate data or even the unavailability of data sources on SMEs, limited experience as well as the lack of research and knowledge in the area.

Presently, up-to-date and comprehensive data on SMEs in Malaysia have been lacking. Most of the available sources of data on SMEs are inadequate and inaccurate. The primary concerns about the available data are:

1) not current;
2) variation in definitions,
3) different units of measurement used;
4) uncertain of their actual numbers;
5) difficult to access; and
6) difficult to verify their accuracy.

The problem of obtaining reliable and accurate data has often been a major constraint for researchers striving to investigate empirically SMEs in Malaysia. The unavailability of reliable, accurate data and the lack of research on SMEs may have also resulted in the limited information on the sector.

Boocock and Wahad (1997) Ling (1990) and Chee (1986) have also indicated in their studies that information on SMEs in Malaysia are still lacking, unreliable and difficult to obtain. This may be due to the limited effort made by the relevant agencies to collect quality information on SMEs on a continuous basis.

Issues from past studies

Over the years years, although SMEs in Malaysia appear to have been able to attract increasing research attention, empirical studies on SMEs iare still relatively limited in scope and fragmented in nature. At the general level, the research focus has been primarily on reporting, and describing their general profile such as personal characteristics of the owners, problems and constraints faced by them and the assistance programs provided by the government. The common characteristics and shortcomings of past research on SMEs are presented below.

Narrow focus

The review of the literature reveals that, in terms of focus, previous studies on SMEs in Malaysia in general, can be grouped as follows:

Focus on demographic characteristics.

Previous researchers focused on observing and reporting the demographic characteristics of SMEs owners. In particular, their major interest was on examining the obvious characteristics of the owners of small businesses such as their education level, marital status, race, sex, age, and experience level (Chee, 1986; Ling, 1990; and Lisa, 1990).

On the other hand, there has been limited research emphasis on SMEs management styles, their organisational structures, culture, stage of development, and their external environment (such as the structure of the industries they are in).

Moreover, few studies have been conducted to investigate the relevant theory of entrepreneurial achievements such as the personality traits of successful entrepreneurs and the competencies required for becoming successful entrepreneurs. Further, the literature suggests that studies conducted to investigate the relationship between the demographic characteristics and the performance of SMEs have also been limited (Chee, 1986; and Ling, 1990) .

Focus on problems faced by SMEs

Majority of the past studies examined and described the problems and constraints faced by SMEs. Most of these studies agreed about the common problems and constraints encountered by SMEs (see Hashim, 1999; and Lisa, 1990; and Chee, 1986). Most of these studies suggest that SMEs faced problems that range from the use of out-dated technology to lack of resources and capabilities to achieve their objectives (Chee, 1986; Hassan, 1992; and Hashim, 1999).

However, the literature suggests there are some common problems and constraints that appear to have resulted from their size. That is, organisational size has some bearing on the problems and constraints faced by SMEs. Welsh and Jerry (1981) stressed that their small size operations and limited resources may leave SMEs susceptible to even minor changes in the efficiency of their operations or to changes in the external environment.

Focus on SMEs assistance programs

Known for their economic contributions as well as their important role in the economy, the SMEs sector has been heavily supported by the Malaysian Government. Most of past studies on the supporting programs reported the agencies and the types of assistance that they have provided (Chee, 1986; Hassan, 1992; and Hashim, 2000). However, little attention has been given to study on the impact and the effectiveness of these assistance programs on SMEs.

Surprisingly, the Government has conducted and published very few studies on the impact of the assistance programs on the operations of the SMEs. Of the few studies conducted, two studies revealed that majority of SMEs owners in Malaysia are still unaware of the various assistance programs (New Straits Times, February 25, 1995 and New Straits Times, October 12, 2000). Another study indicated that the assistance programs were not well utilised by the SMEs sector (New Straits Times, October 30, 1995).

The other studies on the assistance programs are also limited in focus (Chee, 1986; and Hassan, 1992). These studies only reported the various SMEs supporting agencies and the different types of assistance they provided such as training, information, advisory, consultancy, financial and vendor programs.

Limited focus on management practices and relevant theories

Despite the tremendous increase in knowledge in the areas of management such as purchasing, quality, finance, marketing, human resource, operation/production, and strategic management, not much of these management disciplines have been utilised by researchers in investigating SMEs. For example, although strategic management is applicable and relevant to SMEs, there has not been limited attempt to study SMEs from this perspective in the Malaysian context.

Lack of enterpreneurial orientation

As pointed out by Jeninngs (1994), the success of an individual firm depends on factors that can only be observed at different levels of analysis. However, the literature indicates the lack of entrepreneur's perspective as well as multi-level research design in the study of SMEs in Malaysia.

Many of the research on SMEs has been at a single level of analysis (either individual level or organisational level). This single level of analysis may result in a researcher overlooking other key factors that can affect the success of SMEs at different levels of analysis.

Examining SMEs from the entrepreneurial perspective is important in maintaining the notion of the three basic elements of the strategic management - defining an organisation's business and strategic mission; establishing strategic objectives; and formulating and implementing strategy – which are entrepreneurial responsibilities and tasks that requires entrepreneurial skills (Mintzberg, 1973; Miles and Snow, 1978; Drucker, 1987; and Thompson and Strickland, 1987).. Similarly, Greenly (1989) posited that entrepreneurial fair is one of the important feature of strategic management which is concerned with the opportunities as well as risks associated with doing business.

Entrepreneurial approach in the study of SMEs is also in line with the observations of previous researchers who have discovered that SMEs differ from each other in terms of their management styles and sophistication (Carson, 1991; Khan and Manopichetwattana, 1989; Bracker and Pearson, 1986) development (Churchill and Lewis, 1983) and performance (Birley and Westhead, 1990). Further, Lafuente and Salas (1989) asserted that entrepreneurial characteristics can have some influence on the type of firm to be created and how it will be managed.

In line with this view, it is suggested that future research on SMEs should also examine key variables from different levels of analysis. For example, a two-level analysis would involve examining entrepreneurial (characteristics of owners/managers) and organisational characteristics of the firms.

This multi-level approach in studying SMEs will assist in distinguishing between entrepreneurs, non-entrepreneurial managers and small business owners who may lack the knowledge and experience in strategic management, as well as whose businesses may have limited impact on the national economy.

Revisiting the Research Agenda for SMEs in Malaysia

Based on the shortcomings and limitations of past research on SMEs as documented in the small business literature, the following research agenda is proposed.

"New" data sources for research on SMEs

As discussed earlier, up-to-date and comprehensive data on SMEs have been lacking. Whilst some data have been available in fragmented form, data at the micro level have generally been unavailable to the public. Previously, data for research on SMEs in Malaysia were obtained mainly from the following sources:

i) Department of Statistics;
ii) Ministry of International Trade and Industry (MITI) and;
iii) Federation of Malaysian Manufacturers (FMM).

However, the data available from the above sources are not comprehensive and, in most cases, out of date. For example, the FMM keeps data on its member firms only. While, MITI has data on firms that registered with them only. Given such a reality, if we are to witness a more efficient and comprehensive research on SMEs in the future, initiatives must be taken by those concerned to:

a) update the available data; and
b) identify other data sources.

As for identifying the other data sources, the authors were abled to identify several alternative sources. The following Table 1 lists some of these sources.

TABLE 1: ALTERNATIVE SOURCES OF DATA ON SMES IN MALAYSIA

Source:
? 1. The Social Security Organisation (SOCSO)
2. Employees Provident Fund (EPF)
? 3. Local/Town/City Councils
? 4. Tenaga Nasional Berhad
? 5. The Water Supply Department
? 6. The Chambers of Commerce
? 7. The Labour Department
? 8. The State Economic Development Corporations (SEDC)
? 9. The SMEs Supporting Agencies (such as MITI, MARA)
? 10. Small and Medium Industries Association of Malaysia
? 11. Registrar of Companies
? 12. Registrar of Businesses.

More appropriate definitions of SMEs

As noted earlier, currently there is no one overall acceptable standard definition of an SME in this country. In practice, the definitions of SMEs found in Malaysia are based on fixed quantitative criteria such as the number of employees, the amount of capital, the amount of assets and more recently, sales turnover.

However, given the uniqueness of SMEs (in terms of their resources and management styles for instance), any definition based on quantitative criteria is believed to be inappropriate to describe and measure satisfactorily the size of firms in different industries.

Defining SMEs appropriately is important because it has serious implications on the directions of research to be conducted and the formulation and implementation of the related policies. Put another way, a precise and more appropriate definition that reflects the size, the nature and the needs of SMEs is essential and advantageous not only for a particular SME, but also for policy makers and supporting agencies in planning and nurturing the proper growth and development of the SMEs sector as a whole.

Given the importance of a precise and more appropriate definition of SMEs, this paper advocates that more empirical studies should be carried out in this area. As indicated earlier, in attempting to define SMEs, the definition(s) should not be developed based on quantitative criteria alone, but qualitative criteria should also be taken into consideration (Hashim and Abdullah, 2000). Such a practice is common in developed countries such as in the United States of America and the United Kingdom. It is believed that an SME definition that is 'quantitative-qualitative' in nature would be more 'appropriate' to capture the true nature of SMEs in the Malaysian context.

Developing SMEs taxonomies in Malaysia

SMEs consist of different firms and encompasse a wide range of industries. It is generally believed that the presence of a wide variety of SMEs is the manisfestation of imperfections in the economies in which SMEs exist.

Developing taxonomies of SMEs is a prerequisite for explaining how Malaysian SMEs differ. This move can facilitate studies on them. As documented in the literature, in the developed countries several attempts have been made to develop taxonomies of SMEs. The Economic and Social Commision for Asia and Pacific (United Nations, 1992), Rozzoni (1990) and Hosmer, Cooper and Ve sper (1977) have successfully develop three SMEs taxonomies. These three SMEs taxonomies are presented in Table 2 below.

TABLE 2: SMES TAXONOMIES

Taxonomy by ESCAP	Taxonomy By Rozzoni	Taxonomy by Hosmer, Cooper and Vesper.
1. The modern SMEs 2. The traditional SMEs 3. The agro-based SMEs	1. The static small firms 2. The traditional small firms 3. The dominated small firms 4. The imitative small firms 5. The technology -based small firms 6. The new technology -based small firms	1. The mom and pop company 2. The stable high-payoff company 3. The rapid growth company.

Purpose of research

The review of the literature suggests that in the past, much of the research on SMEs has either lacked clarity of purpose or the specified purpose was of little consequence. It is believed that the failure to clearly specify the purpose of the research combined with the lack of common ground for synthesizing research findings has in a way, hindered the advancement of the field in Malaysia.

In this area, it is advocated that future research projects should include a clearer statement of purpose. Furthermore, it is suggested that researchers attempt to link the specific purpose of their study to the fundamental purpose such as to explain factors that can influence their performances and the role of new SME in furthering economic progress, particularly in the Malaysian context.

Theoretical orientation

Theory should necessarily underpin a meaningful and rigorously empirical research. However, as previously highlighted, much of the research on SMEs to date has neglected to examine SMEs from the perspective of modern management theory. Despite the tremendous increase in knowledge in the areas of management theories, little research has been conducted to investigate the relevant and applicability of these theories to SMEs.

Although some researchers claimed that currently not a single theory is available to explain small business operations and growth, it is high time for us to start borrowing theories from the other areas (such as management and economics theories) to help explain SMEs behaviour. For instance, since SMEs are concerned with units of economic activity, attempts to borrow the theory of monopolistic competition can help us explain why certain SMEs adopt product differentiation strategy.

Based either on induction or deduction reasoning, we could attempt to construct theories of SMEs. Likewise, the various theories of strategic management (such as contigency theory, resource-based view theory, socio-cultural theory, and the uncertainty-based theory) could be benefited and exploited to understand, explain and predict SMEs behaviours.

Focus of research and methodological issues

SMEs in Malaysia are heterogeneous in nature: They differ in types of founders, in management styles and sophistication, in stages of development, and in performance. Meanwhile, the research focus on SMEs in this country is very limited and tend to confine to areas such as demographic studies, weaknesses of SMEs, SMEs profile and the types of assistance programs available.

Of the research on SMEs that observed demographic characteristics of SMEs, many suffer from methodological problems such as small sample sizes, non-comparability of samples, and static term of reference. As a result of these shortcomings, any attempt to develop a standard demographic profile would be futile.

Having raised these focus issues and problems, more contextual and process-orientated studies of the Malaysian SMEs are awaited.

Level/unit of analysis

As a field of research, SMEs can be studied at five different levels of analysis. Researchers may choose among the five levels of analysis: individual , group, organisational, industry, and societal. The problem with research on SMEs in

Malaysia to date – as can be found in the literature - has been the tendency of researchers to confine their analysis to single level only.

The relationships between the phenomena that can be observed at different levels or units of analysis are important not just for academics, but for both practioners and public policy makers as well. From the enterpreneur's perspective, the success of the individual enterprise will be affected by factors that can only be observed at different levels of analysis. To miss any one of these perspectives increases the probability that key factors will be overlooked, and that unanticipated events will take the enterpreneur by surprise. From the public policy maker's perspective, the insights generated by multi-level studies have the potential to improve targeting of government efforts to encourage successful SMEs.

In view of this, it is suggested that: future researchers need to examine more than one of the individual, group, organisation, industry, and society levels of analysis. Such multi-level studies provide a much richer understanding of the SMEs phenomena and should therefore be encouraged in future research projects.

Time frame

The literature on SMEs suggests that the concern for wide time frame among researchers on SMEs in Malaysia is almost nil. Of course, in general, short time frame studies are simpler to design and easier to execute but clearly lack the richness of insights as compared to results from studying a phenomenon over a longer time period. For SMEs research, this is important since new firms are extremely fragile and experience many changes and challenges within a short period of time. Often the seeds of future problems are sown in the early stages. Only wide time frame studies will allow us to examine the development problems faced by new firms and to pursue the objective of causal inference.

Having raised the above issue, it is recommended here that more future research should move towards longer time frame (at least three to five years) since different strategic issues become important as firm and industry evolve.

Methodology to be used

There has been slow progress in research that addresses issues of causality in SMEs. Previous studies were mainly in the forms of exploratory case studies or cross sectional statistical studies of the sample survey type. The survey of the literature leads to suggest that there is a need to pursue causality and longitudinal studies more aggressively. As a field of study, SMEs must move to the stage where exploratory case analyses or cross sectional sample surveys that are not theory-driven and do not test hypotheses, are no longer suitable for investigating SMEs since such approaches are very superficial in providing the necessary information to understand, explain, and predict their behaviour.

Conclusion

The present paper highlights important issues as well as attempts to provide a new research agenda for SMEs in Malaysia. Based on the authors' own experience, the information from previous discussions, and the literature on SMEs, this paper identified and proposed nine key areas that are important for better understanding as well as improving our knowledge in SMEs, especially the SMEs in the Malaysian context. The paper begins by identifying and discussing the basic issues which needed to be addressed before proper research on SME could be conducted. The proposed new research agenda is developed based on the various problems and shortcomings of the previous works on SMEs in Malaysia. It is proposed among others, that SMEs as a serious field of study need to be appropriately redefined; that any meaningful study on SMEs should be based on modern management or economic theory; that SMEs need to be investigated from multi-level and wide time frame perspectives. Finally, since the proposed research agenda appears to have never been addressed seriously elsewhere, it is hoped that this paper would provide some contributions towards the development of a healthy and rigourous research on SMEs in Malaysia.

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Strategy of Small Manufacturing Firms in A Changing Environment

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Abstract

Strategic management is a highly important element of organizational success. Strategic success requires a clear understanding of the needs of the market, and the satisfaction of targeted customers more effectively and more profitably than by competitors. Real competitive advantage implies companies are able to satisfy customer needs more effectively than their competitors. It is achieved if and when real value is added for customers. Small organizations which understand their customers can create competitive advantage and so benefit from higher prices and loyalty of customers. Higher capacity utilization can then help to reduce costs.

Management of Small Manufacturing Firms

Entrepreneurship, the spirit of enterprise and the development of small enterprises are leading themes of development transition economics at the present time. They are regarded as essential factors of economic recovery, growth, employment generation and social progress. Entrepreneurs are viewed as individuals who can achieve more then other people in mobilising productive resources and starting businesses that will survive and grow. Small enterprises are a most important parts of the economic fabric of any country because they are flexible and easily adoptable to changing market opportunities, require limited capital, can combine simple and advanced technology as appropriate, while being generally labour intensive and able to create considerable employment opportunities.

Thinking Strategically

In order to be successful, organizations must be strategically aware. They must understand how changes in their competitive environment are unfolding. Organizations have to deal with dynamic and uncertain environments. They should actively look for opportunities to exploit their strategic abilities, adapt and seek improvements in every area of the business, building on an awareness and understanding of current strategies and successes. Organizations must be able to act quickly in response to opportunities and barriers.

Managers perform a number of activities in an organization, including planning and organizing the work of their subordinates, motivating them, controlling what happens and evaluating results. Decisions by managers have a strategic impact and contribute to strategic change.

The organization is shown as one of a number of competitors in an industry; and to a greater or lesser degree these competitors will be affected by the decisions, competitive strategies and innovation of the others. These inter-dependencies are crucial and consequently strategic decisions should always involve some assessment of their impact on other companies, and their likely reaction. [13]

To succeed long term, organizations must compete effectively and out-perform their rivals in a dynamic environment. To accomplish this they must find suitable ways for creating and adding value for their customers.

Strategic management is a highly important element of organizational success. The need to know what the business is about, what it is trying to achieve and which way it is headed, is a very basic requirement determining the effectiveness of every member's contribution. Every successful entrepreneur has this business self-awareness and every successful business seems to have this clarity of vision, even though it does not arise from a formal planning process. [9]

Managers who made long-range plans generally assumed that better times lay ahead. Future plans were merely extensions of where the organization had been in the past. But a number of environmental shocks undermined this approach to strategic planning: rapid technological developments, the maturing or stagnation of certain markets, increased international competition. These changes forced managers to develop a systematic means of analyzing the environment, assessing their organization's strengths and weaknesses, and identifying opportunities for competitive advantage. [10]

In the case of some small businesses external forces can dictate whether the business stays solvent or not. A major problem for many small businesses concerns the management of cash flow. To succeed, a business must have clearly defined objectives and fully developed strategy for achieving them. In short, what is needed is a business plan. A business plan shows the purpose of the business and what it intends to accomplish. A good business plan helps to give form and substance to an entrepreneurial vision, providing a mechanism that enables owners, managers and workers alike to function effectively.

The Competitive Environment

Whilst it is essential for all managers to have some insight into how their organization is affected by the environment, it is also desirable for them to consider how some of the environmental forces might be influenced and managed to gain benefits for the organization. This is less possible generally in the case of small businesses as they are relatively less powerful. However, small companies should examine their environment for opportunities and threats in order to establish where they can gain competitive advantage and where their resources might most usefully be concentrated. [13]

Thinking strategically requires an awareness of alternative strategic purposes and objectives and the ability to recognize critically different environments. In addition it requires the ability to diagnose an organization in terms of various critical characteristics and to be able to shape those characteristics so that the organization is best fitted to its environment in order to achieve its strategic purposes and objectives.

A complex and dynamic modern environment is inevitably difficult to forecast, the inherent uncertainties can make it highly unpredictable and potentially chaotic. Individual managers would develop their environmental and strategic awareness through experience and perception, and by thinking about their observations and experiences. It is particularly important to assess the significance of what happens and what can be observed to be happening. However, in considering future strategic changes there will be an additional need to supplies, customers, competitors, demand, technology, government legislation and so on. Managers who are encouraged to think about future changes, to ask questions and to query assumptions will increase their insight and awareness and this should help decision making. [13]

Effective strategic management involves more than just a few easy steps. It requires managers to thing strategically, to develop the ability to see things in motion, and to make sense out of a cloudy and uncertain future by seeing the interdependency of key factors. This ability requires more than a passing awareness of significant social, political, legal, economic and technological trends.

Managers who think strategically are able to envision their organizations in the context of world trends and events and to spot important interdependencies. They focus on how their organization should act and react to emerging opportunities and barriers.

For any organization certain environmental influences will constitute powerful forces which affect decision making significantly. For some manufacturing and service businesses the most powerful force will be customers; for others it may be competition. [13]

According to Ansoff, the extent to which the environment is changeable or turbulent depends on six factors: changeability of the market environment, speed of change, intensity of competition, fertility of technology, discrimination by customers, and pressures from governments and influence groups. [13] He suggests that the more turbulent the environment is, the more aggressive the firm must be in terms of competitive strategies and entrepreneurialism or change orientation if it is to succeed.

The competitive environment is affected by market structure and profitability; the intensity of competitive rivalry and the degree of differentiation; market growth; the stage in the life of the products or services in question and the frequency of new product launches; capital intensity; and economies of scale. It is important for managers to appreciate where the greatest opportunities and threats lie at any time and focus attention on those areas which are currently affecting the organization and which require strategic attention.

Strategy is about Thinking and Doing

Strategy is not about planning, but about thinking and doing. It is not a technique, but a way of managing the business according to a strategic understanding and perspective. [9]

Strategic management is concerned with understanding, choosing and implementing the strategy that an organization follows. Managers should be aware of the issues, which must be addressed if changes in strategy are to be formulated and implemented effectively. In addition, they should be aware of the managerial and behavioral processes, which take place within organizations in order that they can understand how changes actually come about.

Strategic management is the ongoing process of ensuring a competitively superior fit between the organization and its ever-changing environment. Strategic management is the process that defines the organization's mission, scans the environment to ascertain opportunities, then merges this assessment with an evaluation of the organization's strengths and weaknesses to identify an exploitable niche in which the organization will have a competitive advantage. [5] This process also includes implementation. The best strategy can go awry if management fails to translate that strategy into operational plans, structural designs, systems of motivation and communication, control systems, and other necessary means of implementation.

Strategic management involves awareness of how successful and strong the organization and its strategies are, how the effectiveness of these strategies might be improved, and of how circumstances are changing.

The important issues are: [13]

?? the ability of the organization to add value in meaningful ways, which

?? exploit organizational resources to achieve synergy and at the same time

?? satisfy the needs of the organization's major stakeholders, particularly customers and owners.

The selection of new strategy must take account of these criteria.

The studies of small manufacturing firms competing in a wide variety of industries suggest that obtaining information on several aspects of specific environmental sectors (for example, customers, competitors, suppliers) facilitates alignment between some competitive strategies and environments (that is, industry life cycle stages) whereas the frequency of scanning has no effect on such alignments. [2]

Environmental scanning is generally viewed as a prerequisite for formulating effective strategies. Moreover, effective scanning of the environment is seen as necessary to the successful alignment of competitive strategies with environmental requirements and the achievement of outstanding performance.

Environmental scanning is viewed as the important step in the process linking strategy. Scanning the task and general environment allows a firm to learn about opportunities that it may be positioned to take advantage of and conditions or events that threaten its performance or survival, thus enabling the firm to formulate a competitive strategy congruent with critical environmental conditions. [2]

Organizations must be able to understand the complexity and trends of the changing environment. Some of the changes will be the result of external forces. Others will be the outcomes of actions taken by organization itself. From this learning, organizations must be able to manage change successfully, changing technologies, processes and architecture to maintain a successful match with the environment. In turn this should create positive and beneficial competitive outcomes.

Therefore strategic management in small organizations should involve the following: [13]

?? a clear awareness of environmental forces and the ways in which they are changing

?? an appreciation of potential and future threats and opportunities

?? decisions on appropriate products and services for clearly defined markets

?? the effective management of resources to develop and produce these products for the market – achieving the right quality for the right price at the right time.

Strategic management is effective when resources match stakeholder needs and expectations and change to maintain a fit in a turbulent environment. The external environment consists of suppliers, distributors, customers and customers as well as bankers and owners. If organizations are to be successful – and in many cases, profitable – they have to meet the needs and expectations of their stakeholders. Their relative demands determine what it is that a business must do well.

Therefore, if organizations are to satisfy their stakeholders, especially their customers, whilst outperforming their rivals, their competitive offering should comprise: [13]

?? the ability to meet the recognized key success factors for the relevant industry or market

?? distinctive competencies and capabilities which yield some form of competitive advantage, and

?? the ability and willingness to deploy these competencies and capabilities to satisfy the special requirements of individual customers, for which a premium price can often be charged.

Strategic success requires a clear understanding of the needs of the market, and the satisfaction of targeted customers more effectively and more profitably than by competitors.

Competitive Advantage

Real competitive advantage implies companies are able to satisfy customer needs more effectively than their competitors. It is achieved if and when real value is added for customers.

A business must add value if it is to be successful. The important elements in adding value are:[13]

?? understanding and being close to customers, in particular understanding their perception of value

?? a commitment to quality

?? a high level of all-round service

?? speedy reaction to competitive opportunities and threats

?? innovation.

Small organization which understand their customers can create competitive advantage and so benefit from higher prices and loyalty of customers. Higher capacity utilization can then help to reduce costs.

While it is important to use all resources efficiently and properly; it is also critical to ensure that the potential value of the outputs is maximized by ensuring they fully meet the needs of the customers for whom they are intended. An organization achieves this when it sees its customers´ objectives as its own objectives and enables its customers to easily add more value or, in the case of final consumers, feel they are gaining true value for money.

Business Strategy in an Organization

Business strategy is all about competitive advantage. In general, strategy is to do with long-term prosperity. It is concerned with long-term asset growth, not short-term profit. Thus businesses need strategy in order to ensure that resources are allocated in the most effective way. This is particularly important when it comes to major resource allocation decisions. [7]

The purpose of strategy is therefore not best conceived in terms of its impact on “the bottom line”. Instead it can be identified in more operational terms as setting the direction of a business and achieving a concentration and consistency of effort. In this way inconsistent flitting from short-term opportunity to short term opportunity is avoided and business expertise and leadership can be built up. Finally, the purpose of strategy must also be to ensure an awareness of when change is necessary and thus the ability to be flexible. [9]

Business strategy is concerned with how to make an individual business survive and grow and be profitable in the long term.

The main considerations are as follows:[9]

?? the creation of customers

?? the identification of appropriate market niches where no competition exists

?? the identification of customer needs and how best they can be satisfied

?? the application of technology and its future development or substitution

?? the understanding of competitors and how direct competition may be avoided

?? the motivation of people to put their efforts and enthusiasm behind the strategic aims of the business.

According to Henry Mintzberg, business strategy could follow one of three modes: planning, entrepreneurial, and adaptive. He argues that the right choice depends on contingency variables such as the size and age of the organization and the power of key decision makers. [10]

The planning mode is a strategy approach that includes aclear statement of objectives, asystematic analysis of the organization and the environment, and a plan of action to reach those objectives. Managers should follow the planning mode when the organization is mature and well established, resources are adequate to engage in opportunity analysis, senior management is in agreement as to the organization's objectives, and environmental uncertainty is at a low level. Different conditions may favor one of the other modes.

The adaptive mode is a strategy approach characterized by both the organization's objectives and the means to achieve these are continually adjusted. The organization moves ahead timidly in a series of small disjointed steps. The adaptive mode of strategy making will be most effective when environmental uncertainty is at a very high level, thus focusing management's attention on the short term, and when internal power struggles make it impossible for senior management to agree on where the organization should be going.

The entrepreneurial mode presents a strategy approach in which, a strong leader, usually the organization's founder, draws on personal judgment and experience to form an intuitive image of the organization's direction. This strategy is characterized by bold decision making in which periods of pause are followed by periods of sprinting. The entrepreneurial mode is more likely to be effective when the organization is young and small, when a single, powerful leader has an intimate knowledge of the business, or when crises occur.

Small businesses produce relatively few products or services. Their resources and capabilities are limited. Their strategic options are comparatively simple and narrowly focused. These conditions do not require the sophistication inherent in the planning mode. Strategic planning practices in small firms have been found to be unstructured, irregular, and incomprehensive. They are best described as informal; they are almost never written down and are rarely communicated beyond the chief executive's closest associates. Moreover, the strategic focus in small businesses takes on a more limited time horizon than in large organizations, usually covering periods of two years or less.

Based on Mintzberg´s analysis, we might expect the strategic planning process in small business firms to resemble the entrepreneurial mode more than the planning mode. This is what surveys indicate.

Entrepreneurship and Strategic Management

There are numerous examples of entrepreneurs, who, by reason of considerable success early on, thought they could rely on their intuition only, and failed. In other words, good ideas and visions are necessary but not sufficient; they must be complemented by rational analysis. Strategic management provides for a method, and an attitude to filter the visions of entrepreneurs through rational analysis and decision-making. [14]

The main objective of strategic management is, therefore, to guide the flow of ideas and visions, and convert them into business decisions.

The Strategic Entrepreneurship Concept of Strategic Management in Small Organizations

The concept of strategic management in small organization should be the strategic entrepreneurship concept. This concept incorporates both the intuitive-creative and the rational elements. The strategic process is kicked off by the entrepreneur in the firm, presenting his view on how the organization should develop and what quantitative targets he has in mind. This leads to a vision statement, which outlines how the company should develop and which targets should be met in time. The vision statement is the expression, in business terms, of the entrepreneur's intuitive views. [14]

Following this, a rational process starts with the well-known internal and external analyses, because business decisions require and internal as well as an external situations, as well as the vision of the entrepreneur. In this way the internal and the external analyses provide the criteria by which the final decision can be chosen from a range of options and implemented including controlling.

The process of finding options for the issues is, once more, intuitive. Selection is a rational process, using criteria derived from the vision statement, especially its quantitative targets. The option, which best satisfies the criteria will be selected as the decision concerning the issue. This is the way in which entrepreneurs make their major decisions.

Strategic Approach and Small Firms

Small business managers´ experiences with strategic approach and strategic management point to the need for possible modifications in this process.

First, the process need not be as detailed or lengthy as practiced by large organizations. It could involve simply responding to the questions: [11]

- Where are we?
- Where do we want to go?
- Can we get there?
- How can we get there?
- What decisions must be made to get there? How do we monitor performance?

Second, because of an organization's small size, most if not all key employees can make inputs into the process. This allows the company to use important expertise and contribute to the development of employee commitment and communication. In essence, it becomes a valuable learning experience for all involved.

Finally, top management, or the top manager must be willing to give strategic management a chance. The manager must recognize that his or her company has become a growing enterprise. There is a need for taking the planning out of the mind of a single person and spreading the responsibility around. The benefit of this is that the process of transforming a company into a formal organization is enhanced.

Strategic approach in small firms offers some unique advantages and disadvantages. [11] On the positive side, an organization's small size may not present the complexity and detail faced by strategic planners in larger firms. In fact, the small business may be considered simply a strategic business unit. Other advantages include limited products, services, and markets served, the relatively small resource base, and a limited number of options.

On the disadvantage side, some equally significant issues exist. First and foremost, the executive team is usually small, sometimes only one person. This executive, or entrepreneur, may have always operated the firm from his or her own instincts and sees little use in a ore formalized procedure. Second, information and data to prepare an external and internal analysis may be limited, if they exist. Third, key employees usually have gained their skills through experience rather than with the use of systematic procedures, and resistance to change may develop. Other problems may include the constraint of limited resources and the issue of company ownership.

Planning for Competitive Advantage

If the organization gains an advantage, the business will survive. If that advantage is significant, the organization will thrive.

According to M. Porter, there are three approaches to building competitive advantage: a differentiation strategy, a low-cost strategy, and a third approach frequently used by entrepreneurs is a niche strategy.

A firm that uses a differentiation strategy competes on the basis of its ability to do things differently than its major competitors do. Afirm must truly be unique at something or be perceived as unique if it is to expect a premium price.

A firm that uses a low-cost strategy builds competitive advantage by producing goods or services at the lowest possible cost. And if entrepreneurs persist in their ability to keep costs lower than others, their organizations thrive.

Competitors using niche strategies are specialists. They serve a narrow market segment that can be local or national. Niche strategists build special skills that are uniquely matched to a specific market; they are rewarded with high profit margins. Effective entrepreneurs are aware that establishing and maintaining a competitive advantage is a great challenge. Without careful attention, competitive advantage can be easily lost. [Bate]

The Competitive Specialism

Though an understanding of the business mission is the key to survival, it is not in itself sufficient for high performance. That is achieved by exploiting the competitive specialism.

There are three ways in which the competitive specialism can be exploited. [9]

Firstly, it can be strengthened or intensified so that it is more readily perceived by customers or so that customers accord it a higher value and are therefore prepared to pay a higher premium. Thus, for example, a specialism related to product quality could be intensified by increasing the quality of the product further and/or promoting the quality of the product more effectively. The result will be to increase the actual and perceived level of quality and reduce the price sensitivity of the product.

Secondly, the specialism can be broadened so that it satisfies the needs of more customers. The most obvious way that this can be done is by geographic broadening, but any product which is focused on a arrow segment of the market can potentially have its focus broadened to appeal to other segments.

Finally, the specialism can be prolonged, so that it survives through developing technology and changing consumer tastes.

Intensifying the specialism must only be done with care and on the basis of hard information about customer perceptions. Broadening the specialism also has its dangers. Widening that focus to encompass more market segments risks losing its perceived value to the existing customers. Similarly with prolonging the life of a specialism. Some specialisms are related to single products, or to single clearly defined markets, which have finite lives.

Critical Resources in Small Firms

In a small firm, the key resources are financial resources, the entrepreneur's time and people who work for the firm. [1]

Financial resources are essential. Many unsuccessful entrepreneurs blame their failures on the lack of adequate financial resources. Yet, failure attributed to a lack of financial resources indicates either an actual lack of money or the failure to adequately use the resources available. Those entrepreneurs who fail to use their resources wisely usually make one of two mistakes: they apply financial resources to the wrong uses, or they fail to maintain adequate control over their resources.

Non-financial resources are also crucial to the success of the new business. Well-planned management of time and employees allows the new small firm to counteract the advantages of large firms. The entrepreneur can realize efficiencies by using a network composed of suppliers and customers.

With regard to critical resources, the entrepreneur must demonstrate sensitivity, control, delegation, and creativity. The successful entrepreneur is sufficiently sensitive to the needs of the business to identify the proper allocation of resources, has the good sense to control the use of those resources, delegates work to others, and uses creativity to expand the resource base. The entrepreneur then plans developmental benchmarks for the new business.

The Information Base

Pursuit of an effective entrepreneurial strategy is mainly through information. Identifying the competitive advantages has to be mapped through the collection and analysis of information from existing and potential customers. [1] Developing needed information base is, in practice, aprocess of selection and concentration on pertinent issues. The extent to which information should be maintained depends on circumstances. [6]

Sources of published information are under-utilized because firms, especially small firms, are reluctant to involve themselves in what at first sights appears to be an information jungle which it might be felt is more properly the field of specialist marketing researchers. But published research on existing and potential technology, on markets and on individual competitors and customers is easily identified and accessed through an increasing number of indexing and abstracting services.

In addition to published information strategic management also requires new information about the perceptions of existing and potential customers. This includes very specific and limited items relating to how customers perceive the products available to them and why they buy what they buy. This information too is available to even the smallest firms and the techniques involved in its collection are not unduly sophisticated.

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Constructing a Conducive Environment for the Growth of Knowledge-Based SMEs Through the Establishment of a Science Park

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Abstract

Through the late 20th century, establishing science parks to assist technological entrepreneurs and knowledge-based SMEs has been one of the features of national and/or regional strategies for stimulating innovation. The current paper presents a study probing the elements composing a conductive environment for the growth of knowledge-based SMEs, understanding of which is necessary for effective science park management. Through interviewing 20 executives of tenant firms of Technology Park Malaysia, the third most popular park in the Asia Pacific, the study found that infrastructure, incentive, publicity and service characterize those elements. Both good basic infrastructure and advanced technological infrastructure are their most common needs. Incentives concerning tax advantage, venture capital, grants, and rental subsidies are the second. Increasing publicity and providing technological, secretarial and administrative support/service are also beneficial. These findings provide insights for not only the operation of Technology Park Malaysia but also other parks, particularly those in developing economies.

Introduction

Small and medium enterprises (SMEs) can be found defined differently based on various indicators such as the number of employees, total assets, annual turnover, annual sales etc. In terms of the number of employees, numbers between 100 and 500 are imposed as the upper limits across national statistical systems (see OECD, 2000; Statistics New Zealand, 2002; European Commission, 2003). Although smaller in size, SMEs represent a significant section of both national economies and the world economy. In OECD (Organization for Economic Co-operation and Development) countries, they account for over 95% firms and 60 to 70% employment (OECD, 2000), and contribute up to 25-30% of global manufactured exports (OECD, 1997). In countries such as Italy, South Korea and China, SMEs contribute as much as 60% of total export (OECD 1997).

Entrepreneurs – people who sense opportunities, innovate, take risks and develop new goods and services – are essential to SMEs' development. About 30-60% of SMEs in OECD countries are innovative in such ways as re-engineering products and services to meet new market demands, introducing new organizational approaches to enhance productivity, or developing new techniques to expand sales. Top 5-10% of growing SMEs are exceptional innovators. They tend to be knowledge-based and conduct research and development (R&D). They play a pioneering role in developing new products and markets in sectors such as information and communications technology and biotechnology. In most countries, their job creation rates exceed those of larger companies (OECD, 2000).

Most SMEs have some similar weaknesses. These include insufficient capacity to achieve cost advantage due to lack of scale economies; inadequate financial resources and limitations in managerial and marketing skills which restrict them to compete with larger firms (Ozcan, 1995); a limited range of products and limited links to other firms or groups; and a low tolerance of risk (Dhingra, 1991). In order to assist technological entrepreneurs and knowledge-based SMEs to overcome their weaknesses for successful and quick growth, many governments have applied the strategy of establishing science parks. Science parks are property-based initiatives generally characterized with three features. These are (1) having operational links with universities, research centers and other institutions of higher education; (2) being designed to encourage the formation and growth of knowledge-based industries or high value-added tertiary firms, normally resident on site; and (3) having a steady management team actively engaged in fostering the transfer of technology and business to tenant organizations (IASP, 2001).

Science park schemes of this nature can be found in park/campus-style and center/incubator-style[1]. The park/campus-style is what original science park schemes look like. They are often in a park-like environment, usually adjacent to a higher education institution. They have a low density and a well-designed landscape suitable for knowledge-based firms of different sizes and stages of development. Science parks in this style are actually quite different in size ranging from less than 50 acres to over 200 acres. Center/incubator-style schemes often appear under the name of "innovation center" or "technology incubator"[2]. This type of scheme has restricted space and is usually located in an inner city, close to a university department, where land is tightly constrained. They have a higher building density. Landscaped areas for communal use scarcely exist. They work as prominent mechanisms for promoting the growth of technology intensive businesses by offering accommodation and business support for newly formed firms. In recent years, center/incubator-style schemes have been found often, but not necessarily, associated with park/campus-type developments (see Zhang, 2003). This indicates that a significant proportion of science park tenant firms can be small start-ups.

The establishment of science parks has been one of the features of national and/or regional strategies through the late twentieth century particularly in the Asia Pacific region. The major objective has been to stimulate innovation and generate economic benefits via assisting small knowledge-based firms and knowledge-intensive activities. An increasing number of science parks have bees established to serve this effort. Policy makers in developing countries began to adopt the idea around the early 1980s. This has led to an increasing number of science parks being established in this type of economy (see IASP, 1998; AURRP, 1998; McQueen & Haxton, 1998).

What motivated the current study is the high failure rates of earlier science park schemes as reflected by the literature (see Browne, 1966; Danilov, 1967; Minshall, 1983; Schamp, 1987; Miller & Cote, 1987; Joseph, 1989; Van Dierdonck & Debackere, 1990; Van Dierdonck, Debackere & Rappa, 1991; Luger & Goldstein, 1991), the lack of literature on science park management, and no clue about the perceptions of the demand side of science parks in the Asia Pacific region, namely those technological entrepreneurs and knowledge-based firms, particularly concerning their needs and expectations from a science park. The author perceived it necessary for a science park to know the needs and expectations of its potential tenants so as to assist their growth. Targeting at probing what may be the elements composing a conductive environment for knowledge-based firms in the perceptions of knowledge-based firms, the author conducted a primary study, for which the author interviewed twenty executives of tenant firms in Technology Park Malaysia at the end of 1999. Technology Park Malaysia is one of the earliest science parks established in developing economies. It has been ranked the third most popular science park in the Asia Pacific region (Corporate Location, 1997)[3]. Findings concerned are expected to benefit not only the operation of Technology Park Malaysia, but also other parks, particularly those in developing economies.

Profile for the Park, Interviewees and Firms Concerned

Technology Park Malaysia was established by the Malaysian government to assistant the transition from an agriculture-based economy into a full-fledged industrial economy, which was targeted by Malaysia's Industrial Master Plan (1986-1995) (see Abdul Rahman, 1988, Business Times, 1986; Straits Times, 1988a & 1988b). The park was expected to provide a national focus for action for new business formation and commercialization of R&D; be an active vehicle for technology transfer from the laboratories; provide support for industry and technology and will target specific areas for intervention and assistance; create a community of interest amongst companies and research workers; act as a source of venture capital finance for tenants; be a national exhibition center for new local and foreign technology; be a national information center for technology, including technical, market, management and financial information; be the home of new government R&D institutions and of collaborative regional R&D projects with commercial potential; and be the symbol of technology development in Malaysia (Abdul Rahman, 1988). In 1988, Technology Park Malaysia started as a government unit for park preparation and establishment. It was located in a 2-story commercial building in Kuala Lumpur. An incubation program was offered there with office spaces being rented at competitive rates and assistance of management expertise being provided to tenant firms. The construction of the present park site started in 1993. Phase I was completed in early 1996, when the park team moved in.

The present site of the park covers an area of 750 acres located in the south of Kuala Lumpur (TPM, 2003). It is at the heart of the Multimedia Super Corridor (MSC), the Silicon Valley of the country constructed since the mid 1990s (McGray, 1999; Einhorn & Prasso, 1999). The development of the park is divided into three phases. Phase I, completed in 1996, comprises 12 state-of-the-art buildings including the Resource Center, Innovation House, Incubator Center and Enterprise House. They provide facilities and ready-built units of various sizes for knowledge-based firms. Phase II, which is under construction, includes a Multimedia Center and Biotec City. The Multimedia Center houses a cluster of intelligent buildings serving the physical needs of multimedia companies and enabling them to be service providers to the MSC, the rest of Malaysia and the world. Biotec City will provide facilities assisting companies in the field of biotechnology. Phase III involves the leasing of land lots for individual companies to establish their own buildings for their head offices, research facilities, test sites, and expansion (TPM, 2001). The park leans heavily towards encouraging high-tech companies focusing on such fields as information technology and multimedia, biotechnology and biomedical technology, manufacturing processes, and advanced materials (TPM, 1997). It has 97 tenant firms in the mid 2003.

The author interviewed 20 tenant executives at the end of 1999, when the park had over 80 tenant firms. Convenience sampling method was applied for sample selection. These 20 tenant executives were those who were available at that time and were willing to accept the interview. Three quarters of them were at the top management level; one quarter, at the mid management level. 90 percent had being working with their firms for over one year, and 80 percent had been working in the park for over one year. This reflects that most of these interviewees were quite familiar with the park. In terms of educational background, 90 percent were bachelor degree holders. 70 percent were postgraduates. Among them, 14 percent were Ph.D. holders. Nearly two thirds graduated from a major in science or technology; the others, from commerce. 70 percent had studied abroad. 50 percent had worked abroad. 90 percent were over 30 years old. Most of them were men. Only two were women. Two interviewees were foreigners. The others were local (see Appendix 1).

Among the 20 tenant firms from which these interviewees came, 19 firms were private. Three quarters were purely local, the others had foreign share. 25 percent were very young, established less than two years before. Thirty-five percent had been in operation for two to four years; 40 percent, for over four years. Eighty percent of them had been in the park for over one year. In terms of activities, 90 percent were involved in R&D; half, in providing technological services; 30 percent, in providing business services; one fifth, in specialised production; and one firm, in trade (see Appendix 2).

Needs of Knowledge-Based SMEs

One major open-ended question was used for the interview: "What in your opinion are the needs and/or expectations of knowledge-based firms from a technology park?" Thirteen items were deduced from their answers. These are good basic infrastructure, advanced technological infrastructure, government support, prestige/credibility, internal co-operation, financial support, competitive rental, promotion, technological support, secretarial service, quick response to tenants' needs, co-operation with universities/research institutes, and linkage with tenant firms of other parks (Table 1). Details concerned are as follows.

Good basic infrastructure was proposed by 90 percent of the interviewees. It included a well-managed campus-like environment and facilities concerning dinning, car parking, air-conditioning, lighting, security, mapping, shopping, mailing, recreation, and transportation. A green and peaceful environment was envisaged important for the physical and mental relaxation of knowledge workers, and was also helpful to stimulate their creativity. Night operations of some facilities such as those concerning dinning.

TABLE 1 – NEEDS OF KNOWLEDGE-BASED SMES

N=20

	Needs		F requency	
	Rank 1			
	Good basic infrastructure		1	
	9 referrals to campus-like environment -	8		0
45%				
	Advanced technological infrastructure		1	
	12 referrals to IT facilities/Internet - 60%	6		0
	4 referrals to R&D equipment - 20%			
	Government support		1	
		1		5
	Rank 2			
	Prestige/credibility		8	
				0
	Internal co-operation		7	
				5
	Financial support		5	
				5
	Competitive rental		5	
				5
	Rank 3			
	Promotion		4	
				0
	Technological support		3	
				5
	Secretarial service		3	
				5
	Quick response to tenants' needs		3	
				5
	Co-operation with universities/research		2	
institutes				0
	Linkage with tenant firms of other parks		1	

Air-conditioning and recreation were suggested necessary as R&D people tend to work far into the night.

Advanced technological infrastructure was suggested by 80 percent of the interviewees. It includes two aspects: advanced information technology (IT) facilities and technological equipment for R&D activities. The former is within the concern of more interviewees, 60 percent; the latter, 20 percent. Advanced IT facilities were regarded necessary not only for firms of IT industry, but for all tenant firms' communications and research. Continuous upgrading was expected.

Government support was mentioned by 55 percent of the interviewees. It included incentives concerning tax, grants, and special status for tenant firms. Tenant firms in Technology Park Malaysia could enjoy MSC-status, which granted them a series of financial and non-financial incentives[4]. These incentives benefited their operations.

Prestige/credibility was put forward by 40 percent of the interviewees. It could be from the name of "science park" or "technology park". They envisaged that firms located in a place named with "science" or "technology" were usually regarded as engaging in high-tech activities, therefore, would won more respect and be regarded as reliable.

Internal co-operation was raised by over one third of the interviewees. In their opinion, people with similar talents and traits tended to group together. They could communicate, co-operate, and share equipment and expertise. This might complement or add value to their own work. Park management should arrange joint activities among tenant firms so as to provide more opportunities for their potential cooperation.

Financial support such as venture capital or funds for R&D and/or operation was suggested by one fourth of the interviewees. They agreed that technological entrepreneurs usually had brilliant ideas, but not enough money to start up their own ventures. A scheme of financial support would be necessary in order to assist them. Governmental funds should be channelled to tenant firms for their innovative projects. This would benefit the society in the long run.

Competitive rental was mentioned by one fourth of the interviewees. The major reason was that entrepreneurs and small knowledge-based firms had limited financial resources particularly at their early stage of development.

Promotion was proposed by one fifth of the interviewees. It would make a park and its tenant firms known to the public, which would benefit their development. Exhibitions, shows, and conferences were some of the activities that a park could organize, through which tenant firms could be exposed to the public.

Technological support was suggested by 15 percent of the interviewees. A science park was expected to play a leading role in R&D. It should provide technological support, organize seminars and workshops, and create projects that could assist tenant firms to explore their technological fields.

Secretarial service was proposed by 15 percent of the interviewees. It referred to those services concerning copying, scanning, telephoning and faxing. It would benefit tenant firms, mostly small ones, by reducing their investments and costs if a park could provide them.

Quick response to tenants' needs was also put forward by 15 percent of the interviewees. The reason was some needs could not be anticipated, and various incidents could occur at any time. The willingness and ability to provide quick responses to tenant firms' requirements would be a great support for them. A science park should take an active role to cater for tenants' needs and help them whenever problems occur.

Co-operation with universities/research institutes has two referrals, composing 10 percent of the interviewees. Such co-operation could help to upgrade the profile of a science park. Proximity to a university or research institute could facilitate the co-operation. Co-operative activities with leading international universities or research institutions should also be taken into the consideration.

Linkage with tenant firms of other parks was suggested by one interviewee.

To facilitate comparison, the above needs are divided into three ranks according to their frequencies of referrals. Rank one includes those suggested by more than half of the interviewees; rank two, by 25 to 50 percent of the interviewees; and rank three, by less than 25 percent. Those that fall into rank one are good basic infrastructure, advanced technological infrastructure, and government support. Prestige/credibility, internal co-operation, financial support, and competitive rental are in rank two. Rank three include promotion, technological support, secretarial service, quick response to tenants' needs, co-operation with universities/research institutes, and linkage with tenant firms of other parks (Table 1).

Further analysis shows that these needs fall into four feature groups. These are termed "infrastructure", "incentive", "publicity" and "service", which are listed roughly according to their frequencies of referrals (Table 2). "Infrastructure" refers to both good basic infrastructure and advanced technological infrastructure. "Incentive" includes government support, financial support, and competitive rental. "Publicity" has four elements: internal co-operation, promotion, co-operation with universities and/or research institutes and linkage with tenant firms of other parks. "Service" concerns technological support, secretarial service, and quick response to tenants' needs. Prestige/credibility, is excluded from this classification. The reason is it is derived from the word "science" or "technology" in the name of science parks as suggested by those interviewees, and most parks have either word as part of their names.

Implications and Conclusion

The above findings provide some insights for science park management in their effort in assisting the development of technological entrepreneurs and knowledge-based SMEs. While it has been realized necessary to construct a conducive environment for them to grow well, the above findings suggest the concrete elements, both tangible and intangible, that such an environment is expected to be equipped with. The significance of these findings is that they are from the perceptions of the demand side of a science park, those knowledge-based firms, rather than the supply side. Therefore, they reflect better what a conductive environment for knowledge-based SMEs should be in science park context. Those frequencies of referrals reflect what tend to be the most commonly or less commonly needed elements. Those needs that were nominated by more interviewees apparently are those needed by more firms. Therefore, needs in rank one (Table 1) appear to be those most commonly needed. Those in rank two and three are comparatively less common. While all of them are helpful for the growth of knowledge-based SMEs, these ranks indicate what should be the primary work to be carried out, should a park not be able to achieve all of them at a time.

Both good basic infrastructure and advanced technological infrastructure are what most commonly needed by knowledge-based SMEs. Good basic infrastructure composes the type of working environment that knowledge workers desire. It is human nature to look for the highest possible standard of working and living environment. Whether it is achievable or not depends on personal capability. Knowledge-based SMEs normally house a significant proportion of knowledge workers who are involved in knowledge-intensive activities. This segment of people is sought after worldwide. Due to the significant contribution they may make to the economic development, knowledge workers are crowned as the brain of a society. Virtually every country tried to enlarge its brain of knowledge workers through either "brain drain" (to get foreign knowledge workers) or "reverse brain drain" (to get back its own knowledge workers living abroad). Knowledge workers tend to locate themselves in the type of working and living environment that they refer. There should be no doubt that a science park should first of all meet such a need of knowledge workers in order to have them locate their ventures in the park.

TABLE 2 - CLASSIFICATION OF NEEDS OF KNOWLEDGE-BASED SMES

N=20

Needs	Frequency	%
A. Infrastructure		
1. Good basic infrastructure	18	90
?? 9 referrals to campus-like environment - 45%		
2. Advanced technological infrastructure	16	80
?? 12 referrals to IT facilities/Internet - 60%		
?? 4 referrals to R&D equipment - 20%		
B. Incentive		
3. Government support	11	55
4. Financial support	5	25
5. Competitive rental	5	25
C. Publicity		
6. Internal co-operation	7	35
7. Promotion	4	20
8. Co-operation with universities/research institutes	2	10
9. Linkage with tenants of other parks	1	5
D. Service		
10. Technological support	3	15
11. Secretarial service	3	15
12. Quick response to tenants' needs	3	15

As for advanced technological infrastructure, its importance is decided by the key function of a science park, that is, assisting the growth of knowledge-based firms and knowledge-intensive activities. The technological infrastructure is the tool facilitating the knowledge work being carried out. Small knowledge-based firms or entrepreneurs normally have limited capital at their early stage of operation, let alone purchasing the state-of-the-art IT or R&D facilities, which tend to be capital intensive in most cases. Knowledge-based firms need a location with the facilities concerned in order to keep their knowledge-intensive activities in motion. Getting access to such facilities appears to be obligatory for their further development if they don't have them. A science park that can meet this need will naturally benefit knowledge-based firms. Proximity to a university with research facilities concerned is helpful for a science park to achieve this objective at a lower cost. Good cooperation with such a university will enable park tenant firms to get access to the facilities that they need without or with limited investment from the park. If a science park has already had a university or research institution as its neighbour, the immediate question deserves to ask is whether the tenant firms can actually get access to their facilities, particularly if the park doesn't have the equivalent. Actions concerned will materialize the effect of the strategy of being approximate to a university or research institution, which features the locations of many science parks.

Incentives such as government support, financial support, and competitive rental in most cases relate to monetary support such as tax advantage, venture capital, grants, and rental subsidies. Their frequencies of referrals reflect that monetary support in various aspects appear to be the second common need of knowledge-based firms. Although innovative and ambitious, knowledge based firms lack sufficient financial recourses to achieve their objectives. A science park that can lead them to venture capital assisting their establishment and growth, to grants supporting their work, and to tax advantage to reduce their cost, and provide rental subsidies to share their financial difficulty will certainly benefit their development.

A science park should try every means to increase its publicity. Promotion and marketing are necessary, which will benefit both the park and its tenant firms. They can help a park to recruit more tenant firms and win more support from the society due to increased awareness they can help to build up. Meanwhile, they can help firms in their business development and expansion for the same reason. Cooperation should be established not only mong tenant firms within the park, but also with outsiders in various related sectors. This, on one hand, can help to increase the awareness of tenant firms and provide the opportunities of creating potential values. On the other hand, it will benefit them by opening more channels to various types of know-how. This is particularly necessary in the present age when knowledge has become increasingly integrated, and companies are increasing relaying on outsiders for know-how so that they can concentrate themselves more on their core competences (OECD, 1999).

Knowledge-based small firms do need some technological, secretarial and administrative support or service. However, their low frequencies of referrals indicate that they are not the primary needs of most firms. This could because most technological entrepreneurs are technologists themselves, and most knowledge-based firms have their technologists. They can serve their immediate technological know-how need for their knowledge work. As for secretarial service concerning telephoning, faxing and coping etc., some firms may be able to manage it themselves, therefore this type of service is not the immediate need for most firms either. Nevertheless, the need for external technological and secretarial support or service does exist among some knowledge-based SMEs. A science park providing the support or service concerned will benefit their operation.

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APPENDIX 1- INTERVIEWEES PROFILE

N = 20

Aspect	Classification	Frequency	Percentage
Position	Top management	15	75
	Mid-level management	5	25
Years of working in the firm	<1	2	10
	1-2	8	40
	>2-3	4	20
	>3-5	6	30
Years of working in the park	<1	4	20
	1-2	11	55
	>2-3	4	20
	>3-4	1	5
Education	Ph.D. holder	2	10
	Expert with experience	2	10
	Master	7	35
	Honours	5	25
	Bachelor	4	20
Field of expertise	Management/economics	7	35
	Science/technology/engineering	13	65
Foreign exposure	With foreign education background	14	70
	With overseas working experience	10	50
Age	25-30	2	10
	>30-40	14	70
	>40-50	4	20
Gender	Female	2	10
	Male	18	90
	Malaysian	18	90
Nationality	Foreign	2	10

APPENDIX 2 - PROFILE OF TENANT FIRMS CONCERNED

N = 20

Aspect	Classification	Frequency	Percentage
Ownership	Private	19	95
	Semi government	1	5
Type of firm	A local start-up	6	30
	An independent established local company	5	25
	A branch of an established local company	3	15
	A new local spin-off	1	5
	A JV between local and foreigners	3	15
	A branch of an established local-foreign JV	1	5
	A branch of an established foreign company	1	5
Years of operation	<1	1	5
	1-2	4	20
	>2-3	3	15
	>3-4	4	20
	>4-5	3	15
	>10	5	25
Years in the park	<1	4	20
	1-2	9	45
	>2-3	4	20
	>3-4	2	10
	>4-5	1	5
Business activities	R&D	18	90
	Technological service	10	50
	Business service	6	30
	Specialised production	4	20
	Trading	1	5

Note: JV = joint venture

End Notes

[1] Some literature also classifies city/region-style schemes such as Asian technopolises and European technopoles as science parks. This type of scheme can be either a city or a region in terms of geographic scale. They are associated with governments' regional development plans (Zhang, 2003). This type of scheme is not the focus of the current study.

[2] Science park schemes can be found named differently. "Science park", "technology park", and "research park" tend to be more popular. The present study uses the term "science park" for general discussion. However, where the literature refers respectively for "research park", "technology park" or other names, these terms are used interchangeably.

[3] Evaluation was conducted based on the factors employed by companies looking to set up typical R&D facilities such as quality of research carried out at the nearest university or institute, availability and cost of highly skilled staff, amount of foreign companies attracted, proper costs and the size of the local marketplace (Corporate Location, 1997).

[4] In Malaysia, the government has adopted a range of policies to stimulate the growth of technology and knowledge-based industries and encourage related investments. Incentives have been designed to ensure the long-term viability of companies planning to locate in the Multimedia Super Corridor (MSC). MSC-status has been created for this purpose, which grants companies located inside the MSC with a series of incentives, both financial and non-financial. Tenant firms of Technology Park Malaysia are also granted with the MSC-status as the park is part of the MSC. Financial incentives for MSC-status include a five-year exemption from Malaysian income tax (renewable to 10 years) or a 100 percent Investment Tax Allowance on new investments, duty-free importation of multimedia equipment, and R&D grants for local SMEs. Non-financial incentives include unrestricted employment of foreign knowledge workers, freedom of ownership, freedom to source capital globally for MSC infrastructure and the right to borrow funds globally, globally competitive telecommunication tariffs and service guarantees as well as high class physical infrastructure concerning IT, planned urban developments, educational facilities including the region's first Multimedia University, and a green environment protected by strict zoning (TPM, 1997).

Benefits and Risks of User-Developed Application in Small Business

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Abstract

This paper discusses the benefits and risks of developing computerized business applications by end-users, particularly in the small business environment. As today's end-users are becoming more and more sophisticated coupled with the proliferation of IT that has brought the computerization of business activities within reach of many small firms, understanding the benefits and risks of user-developed applications would contribute towards the small firm's effectiveness in adoption IT. This is particularly relevant in today's managing business in a volatile environment where businesses, including the small firms, will have to compete not only locally but also globally. Therefore, IT is seen as an enabler that can help small firms to increase their competitiveness. Relevant literature on the benefits and risks of user-developed applications was sought and summarized in this paper. Findings were also based on a case study investigation of small firms with no formal IT function. Observations in these firms were made on the end-user developers who were given the responsibility to develop the firm's computerized applications. While the benefits have been enormously highlighted and at times overshadowed the risks, due attention is also given to examining the risks so as to provide a more balanced report, and as the precautionary measures for end-user developers. Risks were categorized according to organizational and individual risks following the application development stages of planning, analysis, design, and implementation.

Introduction

The benefits and risks of user-developed applications to small businesses have been well-documented [Amoroso and Cheney, 1992; Guimaraes and Igbaria, 1996; Alavi and Weiss, 1986; Frank, 1988; Cale, 1994; Edberg and Bowman, 1996; Floyd et al., 1995; Panko, 1998]. Many of these studies contend that the risks of user-developed applications could be potentially lethal to a small firm. However, the fact, that user-developed applications have been pervasive, and continue to grow in small businesses, tells much about their benefits rather than their risks. This phenomenon could be attributed to several reasons. First of all, the risks could be unrealistic and over-zealously reported involving isolated cases. Secondly, firms have taken the necessary precautionary steps to avoid the risks in light of these studies. Third, these risks could act as a 'time-bomb' waiting to explode and even if they do explode, they may go unnoticed in firms that are ignorant of IT. Lastly but not least, firms may realized that many benefits of user-developed applications may outweigh their risks and therefore companies are willing to take the chance. This is particularly true given that hiring of IT professionals could be difficult for small firms due to economic reasons as well as limited supply of IT human resource. No matter what the reasons are, recognizing the benefits and risks of user-developed applications is necessary as today's small businesses readily accept the challenges of globalization by using IT to increase their competitiveness. Recent findings have shown that small firms are now going international with the help of IT, especially the Internet, to enable e-commerce [Westhead et al., 2002].

Benefits of User-Developed Applications

As reported by Amoroso and Cheney [1992] the benefits of user-developed applications are not only specific to the end-users but also to the management and the IS staff as well as to the IS department. Many of these benefits are similar and cited in other studies as well [example see Guimareas and Igbaria, 1996; Alavi and Weiss, 1986]. Even though these studies were based on user-developed applications that appear in large organizations, lessons could be learnt for small businesses as well. While benefits to IS organization such as minimized application development backlog, decreased in IS spending, improved programmer productivity, and improved IS and end-user relations [Amoroso and Cheney, 1992; Guimaraes and Igbaria, 1996] are typical to the traditional large firm set-up, other benefits may also be applicable to small businesses. These include better decision-making, improved in end-user computer literacy, more satisfied end-users, faster response to information requests, direct end-user control of data and information, and increased in end-user productivity. Additional benefits include overcoming the shortage of IT professionals [Alavi and Weiss, 1986], and encourage innovation with less IS bureaucracy.

Within the specificity of small business Raymond [1987] described several benefits of user-developed applications which in addition to some of the above include lower IT investment, less dependent on vendors for application development, lessen the need for hiring IT personnel, and as an alternative to buying packages. Furthermore, as the development's efforts do not require additional financial and human resources, and the fact that today's software is becoming user-friendlier, user-developed applications seem to be more appropriate for small businesses [Raymond and Bergeron, 1992]. In addition, due to the assimilation of IT in most tertiary and training institutions, firms are more likely to hire graduates with higher computer literacy than they were in the past, making user-developed applications in small businesses more practical.

User-developed applications can be seen to be a "natural" solution to the limitation faced by small businesses in respect of effective utilization of their IT resources. It is the nature of small business to be 'poorly' resourced, and since user-developed application do not require the presence of internal IT expertise, users with the necessary development skills would be capable of developing applications appropriate to their needs with no support from the IT professionals. Furthermore, due to the specificity of small business with lack of IT expertise, the gulf between IT specialists and user-developers that may be present in large organizations is no longer an issue in small business. With end-user developer there is no need to hire dedicated programmers and analysts to develop applications and make effective use of IT resources. As user-developed applications evolved within the firms, users become less dependent on third parties and they will be in a better position to evaluate alternatives to IT adoption such as outsourcing, acquiring ready-made packages, or develop their own application. User-developed applications could give added flexibility to small firms to adopt IT as they allow more choices for IT adoption resulting in more flexible approach to effective use of IT.

Risks of User-Developed Applications

Alavi and Weiss [1986] made a comprehensive and widely cited study of user-developed applications' risks. The authors identify potential organizational risks associated with user-developed applications in different stages of the end-user development life cycle and suggest suitable control mechanisms to manage these risks. In the analysis stage, the risks identified include no proper analysis on acquisition of end-user tools and lack of analysis on application requirement. This result in ineffective investment in end-user tools, incompatible software, risks of security and integrity of data, not enough time spent on problem diagnosis and identifying systems requirements, and solving the wrong problem. This finding is also supported by Bronchia and Brown [1993] who found user-developed applications tend to promote incompatible end-user applications, threats to data security, integrity and privacy due to lack of development methods and knowledge of data management, and ineffective use of financial resources when investing in end-user tools, hardware and software. Janvrin and Morrison [1996] agree that user-developed applications will encourage applications developed without regards to any requirements analysis and design and do not follow any structured methods resulting in more errors and less user confidence. The authors also found that end-user developers tend to spend very little time on planning, problem definitions, and diagnosis.

Amoroso and Cheney [1992] found "solving the wrong problem" to be one of the risks associated with user-developed applications. Panko [1998] supports their finding suggesting that omission of errors caused by misdiagnosis of problems has the highest rate of being undetected and "is the most dangerous" of errors. The author further suggests that only few organizations have policies on end-user development that caused end-user (spreadsheet) developers to disregard the use of rigorous development disciplines. This lack of development methods and techniques seems to pose consistent risks in user-developed application what was also echoed in other studies [Amoroso and Cheney, 1992; Edberg and Bowman, 1996; Floyd et al., 1995; and Guimaraes and Igbaria, 1996].

In the design stage, the organizational risks identified by Alavi and Weiss [1986] include lack of documentation, lack of user tests, lack of quality in applications, and redundant efforts on similar development tasks. Moreover, development time has not been spent wisely. Other studies also found unreliable systems due to lack of QA procedures [Brancheau and Brown, 1993; Floyd et al., 1995], no reviews and validation on developed applications [Janvrin and Morrison, 1996], and lack of documentation and testing [Cale, 1994; Edberg and Bowman, 1996]. One other risk in the design stage may include frequent changes in the application design due to lack of development standards and procedures [Floyd et al., 1995].

Alavi and Weiss [1986] categorized risks identified in the implementation stage in terms of the operational and maintenance of end-user applications. In the operations of end-user applications among the risks are threats to the security and integrity of data, and putting additional burden to the corporate computing resources. Frank [1988] found that user department lacked control of file backup, off-site storage, and physical access to sensitive files with lack of control against fire hazards to PC files as the most serious risks. Other related findings include tendency of application development to create pockets of isolated personalized information systems across departments as opposed to an organizational information systems [Brancheau and Brown, 1993]. In addition, end-user developed applications tend to be in conflict with the overall organizational objectives, and tend to withheld valuable information to the knowledge of the organization at the same time retain data which if of little value [Floyd et al., 1995].

For maintenance of end-user applications, failure to document and test changes, and failure to upgrade applications are the two risks identified in the Alavi and Weiss study. In addition, organizations could also incur loss of investment in “personal” applications when the individual end-user that develops the applications leaves the organization [Floyd et al., 1995]. Other implementation risks identified include poorly maintained applications, corruptible corporate data, strained IS-user relationships, information overloading, and lack of integration between end-user and corporate applications [Guimaraes and Igbaria, 1996].

In studying individual end-user developer risks Panko and Sprague [1998] found that not all studies of spreadsheet errors that they encountered are error-free with the number of errors not acceptable in practice. The authors report that about 20% to 40% of all spreadsheet models contain errors and that the most common are omission errors. Logic errors were also numerous when mechanical errors were significantly less. The authors suggest that only systematic code inspections in groups/teams are able to reduce development errors, and minimized individual risks at an acceptable level. However, this study has only examined spreadsheet development when it is very important to examine risks in other end-user developed applications using non-spreadsheet development tools such as word processing, databases, application generators, web- development, and other fourth-generation languages.

Though none of these studies examined the risks of user-developed applications within the specificity of small business, it can still be assumed that most of the risks mentioned are also applicable to the small business environment. Nevertheless, it would be in the interest of IS management in small businesses for separate studies done on end-user development risks and outcomes within the specificity of small business. This paper attempts to present the outcome of a case study of two small firms involved in such user-developed applications.

The Case Study Approach

Information systems have been recognized as multi-disciplinary [Brancheau and Brown, 1993] and the multi-faceted nature of IS research has made case study research an appropriate research strategy [Cavaye, 1996; Remenyi and Williams, 1996]. Furthermore, studying contemporary events in their natural settings is more appropriate in a qualitative research method where case study research has emerged as a suitable candidate [Yin, 1994; Mason, 1996]. Since IS is multi-faceted, therefore it is appropriate to employ the case study approach as a research strategy for this study.

Two firms were used as respondents from a list of prior survey [Dahalin and Golder, 1998] consisting of respondents representing different levels of sophistication in terms of IT adoption. Both firms were chosen with no formal IT function and no IT professional. Both were categorized as small manufacturing firms involved in the steel-making industry, where one firm is involved in making steel tubes for the heat transfer industry and the other is in the business of making cold drawn seamless steel tube product. Data collection and analysis were done on these firms and findings from the cases are presented in the next section.

The primary data gathering technique used is through semi-structured interviews whilst other sources of evidence used, include company documents and observations. 15 interviews were carried out in both firms involving the end-user developers, the firms' senior management team, and other end-users. Each interview lasted between 1 to 3 hours for duration of 3 months. A further three months were spent for data transcription and reviews of the interview scripts, and another 2 months for analysis and preparation of reports.

Analysis of Findings

A pattern-matching strategy proposed by Yin [1994, p. 106] was used to compare the data as an empirically based pattern of evidence. This is to ensure the findings are based on strong internal validity of the cases. A cross-case analysis is presented to compare data from both firms where patterns could be established. This would enable similar or contrasting results to be obtained, consistent with Yin's suggestion on literal replication and theoretical replication [Yin, 1994 p. 64]. A cross-case summary of the firms' characteristics is presented in Tab.1 to reiterate some of the main findings already discussed previously. Obvious similarities and differences can be seen in the three categories of the firms' basic profile, IT adoption and end-user developed applications.

TABLE 1.
SUMMARY OF FIRMS' CHARACTERISTICS

Characteristics	Firm A	Firm B
1. Basic Profile		
?? Ownership	?? Family	?? Family
?? Industry	?? Manufacturing	?? Manufacturing
?? Age	?? 10 years	?? 70 years
?? Size (staff)	?? 45	?? 49
?? Sales (million)	?? 6.0	?? 4.5
2. IT Adoption		
?? Years using IT	?? 3	?? 15
?? No. of PCs	?? 18	?? 6
?? No. of Users	?? 18	?? 9
?? IT Support	?? Nil	?? Nil
?? No. of systems/IT products	?? 10	?? 3
?? No. of applications	?? 13	?? 13
?? CEO Support	?? Strong	?? Weak
3. End-User Development		
?? End-User Typology	?? 1 – End-user developer	?? 1 – End-user developer
?? Applications developed	?? 3 – Command level EU	?? 1 – Command level EU
?? Source of end-user support	?? 12	?? 9
?? Experience in development	?? Self-supported	?? vendor/training
?? Planning for development	?? 4 years	?? 7 years
?? Development Policy	?? Not documented	?? Nil
?? Development methods	?? Informal	?? Nil
?? Development responsibility	?? Not standardized	?? Not standardized
?? Documentation	?? Part time	?? Part time
?? User tests	?? Minimal (scratch)	?? Nil
?? Security/backup procedure	?? Nil	?? Nil
	?? Yes, informal	?? Nil

Some of the data presented above provide support for previous studies on IT adoption in small business, whilst other evidence may suggest the contrary. The capability of small firms to develop their own applications confirms earlier studies [Raymond, 1985; Lees, 1987]. The lack of IT support is typical of many small businesses [Doukidis et al., 1996; Raymond, 1990]. A strong CEO support implies an increase in IT adoption [Thong et al., 1996]. This is supported by the pattern of evidence on the number of PCs, and the number of users as well as the number of systems, and IT products on one firm in relation to the other. In addition, data on end-user developed application shows that in the absence of experience in application development, training can be an alternative to encourage end-users to develop applications as suggested by Raymond [1988]. Conversely, this also implies that in the absence of training in application development, on-the-job experience can also become an alternative to encourage end-user application development as demonstrated by Firm A.

Contrasting results can also be seen based on the data presented. There is no evidence to suggest that the firms are experiencing difficulty on developing applications due to having users with low level of computer literacy as suggested by Montazemi [1987, 1988]. However, difficulties have been experienced in other areas such as time constraint in the development, limited human resources, and firm's profitability in relation to application development. Both firms have never suggested the lack of technical knowledge as a form of difficulty or obstacle to application development.

Among the organizational risks associated with user-developed applications identified in the planning stage of the case study, firms include lack of formal planning in application development and lack of strategy for implementation as presented in Tab.1 above. Though, there was evidence of an informal policy on user-developed application in one of the firms, decision to develop an application is usually short term and depends on the availability of the end-user developer. In the other firm, applications were developed as and when the developer moved to different departments. This resulted in contention among the departments trying to win over the only expertise available. Individual risks appear to be the lack of planning knowledge and lack of formal management training.

In the analysis stage, the organizational risks identified include lack of analysis on user requirements, lack of development methods and techniques, and threats to security and integrity of data. However, there is evidence of proper analysis on acquisition of development tools and ensuring compatibility of all hardware and software used. On user requirements, there was evidence suggested that application development was done without consulting other users as the user-developer thought it unnecessary to seek users' input due to the developer's own knowledge and experience in the business itself far surpassed the other users. However, this resulted in less user satisfaction with the applications. Lack of formal training in development methodology has also contributed to this as well as the problem of discovering errors too late in the development stage. On individual risks, as well as the lack of formal training by the end-user developer in one of the case study firm, substantial amount of time was spent on performing diagnosis and trial and error during application development. The part-time nature of the development work has also made the whole development task more challenging and difficult.

A consistent risk found in the design stage is the lack of documentation on the applications developed. A common excuse was the lack of time as the developer has to either catch up with the backlog on his formal work or had to move on to developing other urgent applications. Another organizational risk in the design stage is the development of similar applications used by different departments within the same firm. In the case study, an example is the existence of three separate stock control applications, two keeping track of the same parts used by the Sales and Productions departments, and one for material control application used by the Production department. There was evidence of user tests being done before implementation but that was used more as a platform for user training than for validation and QA procedures. One individual risk identified in the design stage is the frequent changes in the design due to the lack of standard design method. This is exemplified in one of the firms' cases where the Order Processing system went through three major revisions in three years. The third revision was an oversight on the cascading problem in the design of the database due to failure to perform appropriate relational normalization. This could be seen as an "omission error" suggested by Panko and Sprague [1998] discussed earlier.

In the implementation stage, the organizational risks identified include, lack of control over security of the development tools and backup of files. Though these are also risks associated with the general IS issues, they are also user development risks as it involves operations of user-developed applications. One of the case study firms relates an incident where its PCs located in one of the department were stolen and because there were no backups; applications used by the department had to be developed from scratch. The situation got even worst when users from another department were affected when their PCs were needed to re-develop the stolen application! There was also individual risk in the implementation stage where an application developed by an end-user was not formally recognized but continued to be used by several other end-users in the department. Ignoring such talent would not benefit the firm and there could even be potential loss of investment in such "personal" applications when the end-user that develops the application leaves the organization.

Conclusion

Whilst there are many benefits associated with user-developed applications, understanding the risks is a first step towards developing the successful user-developed applications. This paper highlights the many possible risks a small firm may encounter in its endeavor to develop its own application with the aim to avoid such occurrence so as the development risks could be minimized. Only through carefully management of these risks, can small firms reap the full benefits of user-developed applications and be in a position to utilize IT for their competitive advantage. From the case study investigation, it seems reasonable to suggest that end-user application development in the small firms should be properly planned and not left to individual initiative. Top management should be aware of their internal talents and be more receptive and supportive of the development efforts. Instead of putting constraints on user-developed application, management should allow this trend to pervade across the firm and provide the necessary tools, training, policy, and incentives that would encourage the innovative and development culture.

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Developments in the Level of Marketing in Czech Firms between 1999 and 2003

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Abstract

At the current time, when, as a result of the rapid developments in Information Technologies, frequent changes occur in the surrounding environment and in customer preferences, and where it is often necessary to implement changes to approaches in practice in firms, Marketing and its philosophies are becoming ever more important.
Marketing activities do not only concentrate on discovering the best methods for persuading customers to buy products, but also include the seeking of further opportunities for creating new values for customers, which it is then necessary to set in context with the current and future marketing environment of a firm and concurrently, to respect the real abilities of these firms.

Marketing is one of the key pillars of the successful management of an enterprise, since the primary role of marketing is the creation of value for customers. "New Millennial" Marketing is a philosophy, a method raised to the way of thinking, where the marketing management of a firm must always think about and deal with a regard to the current and future customer. In this philosophy, the most important is the ability to understand one's customer and market, to have the right product in the right place at the right time, and to be certain that the customer is sufficiently informed about the product. Marketing is an indivisible component of those processes that link the abilities of an enterprise to the requirements of its customers. To what degree Czech firms devote their attentions to marketing activities and are aware of its contributions and benefits for the prosperity of the firm formed the framework and was the subject of two research studies we conducted in 1999 and 2003.

Introduction

Marketing is one of the basic pillars of the management and directional-orientation of business. It is oriented on the customers, and represents not only a source of information about them but also about competitors and the overall entrepreneurial environment. It covers the domains of the long-term relationships of enterprises and their customers, as it does for the short-term Sales activities.
The primary role of Marketing is value-creation for an enterprise's customers. Successful value-creation for its customers in turn leads to value-creation for other materially-interested entities, i.e. including owners, shareholders, and employees.

Sales - as compared to Marketing, involves the direct persuasion of the customer, to buy the product, while Marketing is a philosophical issue, which assists in the maintenance of a balance between the aims and objectives and the possibilities facing an enterprise.

A whole range of Czech enterprises still mix up these two terms and are unable to comprehend that a Sales Department, oriented as it is on increasing sales and the saleability of existing products cannot, at the same time, afford to think about and speculate over new trends and changes in the surrounding environment, or even – about new consumer preferences.

Marketing activities concentrate not only on discovering the most effective means of convincing one's customers to buy the product, but also include searching out further possibilities (opportunities) for the creation of new value-added properties for one's customers. Searching is subsequently necessary to put into context with current as well as future marketing environments, while respecting the actual abilities of the enterprise at the same time.

In mid-2004, when the Czech Republic will finally become a fully paid up member of the European Union, Czech enterprises will be faced, more than ever before, with the enormous European marketplace. These Czech enterprises will have to reconsider their entrepreneurial strategies – in order to take into account this pan-European dimension with its great quantity of competitors, and to know just how permeable these markets are, as well as their (potential) customer and competitor behaviours. Even those producers operating on a purely local level in local markets will be unable to avoid the requirements imposed by a unified pan-European market – as regards prices, quality, the technical and Health & Safety parameters of the products, the ways and means of its propagation and promotion, its distribution, and of its After-Sales Service.

A new marketplace is already taking shape, filled with an enormous number of world-class competitors. The ability to be flexible and to react quickly to a new impetus or impulse from the market will bring these enterprises profits. However, the satisfaction of special requirements (demands) requires the commensurate knowledge and agile exploitation of marketing tools. The questions remain - Do in fact Czech enterprises exploit such marketing tools?, Are they aware of the advantages and benefits flowing from well-performed Marketing activities?

Problems, Issues and Hypotheses

Beginning in 1989, and over the course of the last 14 years, the Czech Republic has undergone enormous transformation from state-held enterprises and a centrally-planned economy to a private, market-led economy, in which each must ensure the take-up of their products themselves, through their own powers. Marketing – the promotion of an enterprise's products, and Advertising were completely unknown terms to Czech enterprises until shortly after 1989. What endured was the statement that the product was the most important/key, and by no means has this been replaced by the customer's needs, since Czech enterprises underestimate the powers of Marketing and very often, freely interchange this term with that of Sales [Rehor, V., 1995; Mozga, J., 2000].

The employees of Marketing Departments of enterprises hailing from EU countries often have a more detailed understanding of a Czech customer's needs and so often know them better than domestic manufacturer's do, since sophisticated marketing and customer care are, in the great majority of Western European enterprises, a simple matter-of-course [Šmejkal, V. and Coll., 2000].

Indeed, this is precisely why, with a view to the situation prevailing in Czech enterprises regarding developments in Marketing, this area has become the subject of investigation. It has proved, highly interesting to follow, how Czech enterprises have accepted marketing-related activities, and whether or not they see them as offering a contribution or benefit for their enterprise and for their future success in maintaining their position on the markets.

At the present time, as a consequence of the rapid expansion of new information and communications technologies and the acceptance afforded by their built-in advantages to both enterprises and customers, the Internet would appear to be essential to marketing practices above all. Czech customers have still to fully exploit the opportunities to purchase goods through the Internet, and to catch up with the Most-Developed Countries (MDCs), and, as OECD statistics show, Internet visitor numbers ("hits") per 1,000 inhabitants for the Czech Republic does not yet rank them among these MDCs [OECD. Information Technology Outlook, 2002].

The aim of the research undertaken was to gain information as to the state of Marketing in Czech enterprises, as well as whether changes in the perception of the importance of Marketing practices in the course of the period covering 1999 to 2003 took place. At the present time, marketing activities are indivisibly linked to the development of the Internet – which has become a highly-prized information and communication channel for these enterprises.

The following hypotheses were postulated:

H1: Czech enterprises underestimate (the value of) Marketing activities.

H2: In the course of 1999 to 2003, a shift towards strengthening the significance of these Marketing strategies occurred in Czech enterprises.

H3: The introduction of the Internet into Czech enterprises has grown over the course of the period: 1999 to 2003.

The answers to the above-mentioned hypotheses were sought through intensive investigations into the following areas:

-The Existence of an Independent Marketing Department.

Marketing is one of the basic pillars of the management and directional-orientation of business. [Kotler, P., 2000]. As it is agreed by a number of authors [Kotler, P., 1998; Murphy, 1996; Bendaly, L., Cates, L., 1999; et al.], an independent Marketing department is – above for larger enterprises, a very important aspect for the performance of high-quality marketing activities. These authors all draw one's attention to the difference in aims and objectives that are tracked from a Marketing and Sales point of view.

-The Standing of the Marketing Department within the Overall Organisational Structure.

The functionality of an existing Marketing Department can be judged in perspective of its situation within the overall framework of the organisational structure of an enterprise. What is the key in the development and functionality of the marketing activities in an enterprise, which are oriented on the customer themselves above all. For this reason, in order for an enterprise to be able to fully exploit the advantages and benefits that are the fruit of well-conducted marketing activities, it is essential that the Marketing Department's employees not be dependent upon the Sales Department. [Kotler, P., 1998; Capon, N.; Hulbert, J. M., 2000].

-The Education-base of the Marketing Department's Employees.

The qualities of the actual employees employed in a Marketing Department form an important aspect of well-performed marketing activities. Their knowledge, skills, and qualifications become an essential component of all of an enterprise's activities. What above all decides the competitive ability of an enterprise is its intellectual capital - since the qualified employee is, intrinsically, the greatest capital an enterprise possesses [Kelly, K.1999]. Siegel, D. [1999], sees the opportunity for an enterprise as not residing in their financial capital, but in the intellectual capital of its employees.

-The Marketing Strategy in Enterprises.

It is very important that an enterprise sets out its marketing strategy in order to be able to achieve the marketing aims and objectives set out in it. [Tomek, J.,1998].

Purchasing power is growing accompanied by a differentiation in customer preferences, which plays into the hands of operative (pro-active) enterprises. The transformation of a marketing orientation on the masses to an orientation on targeted groups, and indeed, in the future to one targeted on the individual needs of a single customer, which should prove feasible thanks to new communications technologies.[Kotler, P.,2000]. This is precisely the (detailed) knowledge of one's customers that will play a decisive role in the future in the course of strategic decision taking and subsequently, upon acquiring a strong position on the market [Strauss, J., 2000]. The customer is becoming the cornerstone in the value-creation process, and will become an essential component of the newly originated product [Terpstra, V., 2000]. The enterprise must target itself on its customers and require from its Marketing Department a detailed knowledge of the problems and issues facing these consumers. Moore, G. A., [1999], points up the rapidity of changes in both the entrepreneurial environment and consumer preference, while at the same time pointing out the unwillingness of managements to transform run-of-the-mill (tried and tested) ways of doing things.

The need for change in this new, digital age, and above all a change in strategies, is emphasised by Wurster Thomas and S. Evans Philip [1999], who emphasise that no enterprise, however dominant it may be in its branch, is immune from the drastic transformations currently under way in today's Information economies.

Christopher, M.[2000], talks about the fragmentation of consumer markets and proposes a conception of "Micro-marketing", in an attempt to precisely target marketing strategies on ever-diminishing customer segments.

-The Implementation of the Internet in Enterprises as an Ineluctable Component of Marketing Activities.

Working with information is an ineluctable (indivisible) component of marketing activities in general. The ability to gain a jump on one's competitors is closely connected to the introduction and exploitation of the Internet into enterprises in acquiring information about markets, customers, and even one's competitors. These electronic tools have been in use for some time now in marketing practice. Despite this, the enormous expansion of the Internet and other new technologies has had, as its consequence, the origin of completely new aspects of marketing practice.

Hartman, A. and Kador, J. [2000]; Christopher, M. [2000]; Strauss, J.[2000]; Tvede, L., Ohnemus, P. [2000]; Siegel, D.[1999], all of these afore-mentioned are in complete agreement on the necessity for a customer-oriented marketing strategy. Siegel, D.[1999], sees the future of enterprises in their preparations for the new world of "e-customers", in which they assist enterprises in taking the correct strategic decisions – as long as the enterprise grants them the chance to do so. Stan Rapp and Chuck Martin [2001], state that the link between e-shops and their e-customers will be ever more radically different that it was in the past. There will be an ever-clearer shift away from mass-marketing towards a more segmented market and the seeking of market niches, i.e. towards so-called individualised marketing. A whole number of works contain the statement that, thanks to the Internet, the customer will gain an upper hand and have the advantage - since not only the employees of an enterprise, but in the same manner its customers, are able to be very well-informed. [Stan Rapp and Chuck Martin, 2001], [Siegel,D.,1999].

Research Methodology

The main area on which our research study was oriented was the marketing activities of Czech enterprises. An effort was made to comprehend and give a clear picture of the approach of these enterprises to marketing activities, and as to whether a change in their perception of the significance of Marketing had taken place in the course of 1999 to 2003.
The research was mainly oriented on the following areas:
a) The existence of a Marketing Department in the enterprise; its standing within the overall framework of the organisational structure; who actually was working in these departments; and whether these enterprises had established a marketing strategy.
b) To what extent the enterprise was equipped with the Internet, and just how the Internet was exploited.

Research into these enterprises took place within differing two time-frames in order to be able to gain sufficient information about any changes, and developments in the approaches of these enterprises to Marketing. The first investigation into the behaviour of Czech enterprises in the Marketing domain took place in 1999; the second took place at the beginning of 2003.

The enterprises were supplied with questionnaires, which began with general questions as to the ownership structure of the enterprise, the management of the enterprise, the number of employees, and the branches in which the enterprise operates.

The second part of the questionnaire was devoted to the existence of a Marketing Department in the enterprise, what standing this eventual Marketing Department had within the overall framework of the organisational structure, what education the Marketing Department's employees had, and whether the enterprise had established a Marketing Strategy for itself.

The third part of the questionnaire was devoted to questions regarding the Internet, its introduction, and its exploitation within the enterprise. The 2003 research study was expanded by questions regarding the enterprise's web pages, whether they had their own, and whether these were used exclusively to promote the enterprise as a whole or whether they included a Product Ordering system.

Characteristics of Respondent Enterprises

The subject of this research study were enterprises in Czech proprietorship, since the enterprises so investigated were managed by Czech managements.

In order to be able to gain a more detailed and consistent elaboration of the outcomes of the research study, the individual problems and issues were investigated separately and based on the size of the enterprise such that this interpretation would be as complete and clear as possible. The enterprises were categorised according to their size – based on the number of employees.
Very Small Enterprises were designated as having 0-19 employees; Small Enterprises as 20-49 employees; Medium-large Enterprises as 50-249 employees; and Large-scale Enterprises as 250 and more employees.
Tab. 1 shows the categorization of the enterprises studied in 1999 and 2003 by size.

TABLE 1. ENTERPRISE CATEGORIZATION - 1999 AND 2003, BY SIZE.

		? of Enterprises.			
		1999		2003	
Enterprise Category:	? of Employees:	Absolute:	%	Absolute:	%
Very Small	0 - 19	168	52	113	41
Small	20 - 49	56	17	50	18
Medium-large	50 - 249	63	20	69	25
Large-scale	250 and more	37	11	44	16
	TOTAL:	324	100	276	100

Data Collection

In both investigations, we approached enterprises in the Czech Republic on a random basis. Our efforts were guided by the desire that the representative nature of these enterprises according to their size (employee numbers) reflects to a certain extent the actual distribution of such enterprises in the Czech Republic, in order to be able to gain a certain degree of certainty as to the ability of the outcomes discovered to faithfully reflect as a true picture as is possible.

The individual enterprises were approached on a personal basis (visits), since the questionnaires were completed on the spot by a research team member working in conjunction with the management of that enterprise.

In the course of acquiring this data, a number of students of the Faculty of Management and Economics at Tomas Bata University in Zlín assisted - most of these were drawn from the ranks of junior academic staff (Doctoral students and research workers).

Results

The subject of this research study was, above all, to gain a picture of the state and standing of Marketing in Czech enterprises, and whether their representatives were aware of the importance of Marketing for the future standing of that enterprise in its market. One of the fundamental assumptions was that, for an enterprise to be able to fully exploit and reap the benefits and advantages that a well-conducted marketing activity can bring, is the need for the employees of the Marketing Department to be independent and not to be dependent upon the Sales Department. At first glance, based on the outcomes of this research study, viz. Tab. 2., it can be stated that the majority of the enterprises consulted did not have their own independent Marketing Department. Whereas, in the course of the period between 1999 and 2003 a shift towards a greater number of Marketing Departments had occurred in these enterprises; i.e. from a total of 25% of the enterprises consulted in 1999 who indicated the existence of an independent Marketing Department, by 2003 this number had increased to 33%. What seems highly important however, is the view of the size of individual enterprises. As can be seen from Tab. 2., the majority of these enterprises do not have an independent Marketing Department; this number is however predominantly made up of Very Small Enterprises and Small Enterprises, where the independence of such a department must be considered within the context of the overall cost involved and also the benefits that might arise. Small Enterprises have to weigh in the balance whether such an institution would bring them, apart from increased costs, increased additional profits. It can be seen that for Small Enterprises, the period 1999 to 2003 does not show any marked shift, the given state regarding the question of an independent Marketing Department is constant.

The situation is different however, if we consider the Medium-large and especially, the Large-scale enterprises. An increased perception of the need for an independently operating Marketing Department is especially clear with the Large-scale enterprises, where from a level of 57% in 1999 it grew to 70% in 2003. It therefore flows that it is especially with these Large-scale enterprises which most clearly see a benefit in the marketing function, since it is possible to track a growth of 23% in this segment in the number of such departments. From this, it is possible to state that Large-scale enterprises in the Czech Republic see a clear benefit for themselves in the marketing function, and that ever more frequently, independent Marketing Departments are being created.

TABLE 2. THE EXISTENCE OF AN INDEPENDENT MARKETING DEPARTMENT
COMPARISION BETWEEN 1999 AND 2003.

	The Existence of an Independent Marketing Department.											
? of Employees:	1999						2003					
	YES:		NO:		TOTAL:		YES:		NO:		TOTAL:	
	Abs.	%	Abs.	%	Abs.	%	Abs.	%	Abs.	%	Abs.	%
0 - 19	20	12	148	88	168	100	16	14	97	86	113	100
20 - 49	12	21	44	79	56	100	12	24	38	76	50	100
50 - 249	28	44	35	56	63	100	32	46	37	54	69	100
250 and more	21	57	16	43	37	100	31	70	13	30	44	100
Sub-Total:	81	25	243	75	324	100	91	33	185	67	276	100

The functionality of existing Marketing Departments can be judged from the perspective of their positioning within the overall framework of the organisational structure of the enterprise. Since in cases where the given department forms a part of the Sales Department, or even, is subordinated to the same, it proves that is very difficult to achieve the set of marketing aims and objectives, which are frequently markedly different to those of the Sales Department.

The outcomes of this research study shown in Tab. 3, demonstrate the actual functionality of an independent Marketing Department.2

Of 81 enterprises, which indicated in 1999 that they had an independent Marketing Department, 18% were directly subordinated to the enterprise's management, 61% were on the same level as the Sales Department, and in 21% of all cases, the Marketing Department was subordinated to the Sales Department. In 2003, of 91 enterprises which had an independent Marketing Department, in 37% of all cases this department was directly subordinated to the enterprise's management, 53% were on the same level as the Sales Department, and only 10% of all enterprises indicated that their Marketing Department was subordinated to their Sales Department. Overall, it can be stated that, for Czech enterprises, the Marketing Department is now most frequently ranked on the same level as the Sales Department.

However, in the course of 1999 to 2003, it has been shown that there has been a shift towards a perception of the right to direct itself and accept responsibility of Marketing Departments, and that there has been a significant decrease in the number of enterprises in which the Marketing Department is subordinated to the Sales Department and an increase in the number of enterprises where the Marketing Department is subordinated directly to the enterprise's management or else, is ranked on the same level as the Sales Department. If we consider this issue from the perspective of the categorisation of the enterprises by their size, this change can be noted for all size categories. It can be stated that, should an enterprise today decide to create an independent Marketing Department, they are now much more aware of the importance of its organisational ranking and the level of responsibility allocated to it than they were 4 years earlier.

Table III. THE MARKETING DEPARTMENT WITHIN THE OVERALL FRAMEWORK OF THE ENTERPRISE'S ORGANIZATIONAL STRUCTURE

	The Marketing Department within the Overall Framework of the Enterprise's Organisational Structure.															
	1999								**2003**							
? Employees:	Directly Subordinated the Managem		Same level Sales Department		Subordinated Sales Department		TOTAL:		Directly Subordinated the Managem		Same level Sales Department		Subordinated Sales Department		TOTAL:	
	Abs.	%	Abs.	%	Abs.	%	Abs.	%	Abs.	%	Abs.	%	Abs.	%	Abs.	%
0 - 19	3	15	9	45	8	40	20	100	7	44	8	50	1	6	16	100
20 - 49	3	25	4	33	5	42	12	100	4	33	8	67	0	0	12	100
50 - 249	3	11	12	43	13	46	28	100	9	30	17	57	4	13	30	100
250 and more	6	29	14	67	1	4	21	100	14	43	15	45	4	12	33	100
Sub-Total:	15	18	49	61	17	21	81	100	34	37	48	53	9	10	91	100

The educational level of the enterprise's employees, levels of education attained so far, qualifications- these are all further assumptions for the correct functioning of an enterprise.

The educational levels, knowledge of the given problems and issues, and the overall view these give of a Marketing Department employee's effect on their work can influence an enterprise´ s (commercial) outcomes to a great extent. It can be assumed that a university-level educated employee working in a marketing function should be better prepared to meet the demands made of them by the enterprise's management.

In enterprises with an independent Marketing Department, we were interested in the level of education attained by the employees of that Marketing Department; since, as a consequence of the long-term period in which neither the market nor the market-driven environment simply did not exist in the Czech Republic, a feeling that the lack of importance of the Marketing function prevailed and predominated in a number of Czech enterprises for a long time afterwards. The Marketing Department was often created simply because it was "modern - and (any self-respecting) enterprise should have one" - but the staffing and job-content/role of such a department, were no longer considered to be important issues.

After studying Tab. 4., overall it can now be stated that the majority of Marketing Department employees are holders of a university degree, whereas Marketing Department employees with a basic education are now the exception rather than the rule.

If we look at the enterprises from a size perspective, we can see that especially for Small Enterprises, the shares of Secondary School-educated Marketing Department and University-educated employees are now equal, and that little has changed over the last 4 years. For Medium-sized and Large-scale Enterprises, the turn away from a Secondary School education is noticeable. With the latter, there is a markedly visible preponderance of University-educated Marketing Department employees. Over the course of the period being followed, the share of the number of University-educated employees in these posts has grown significantly, which is a very positive trend.

Table 4. THE EDUCATIONAL LEVELS OF MARKETING DEPARTMENT EMPLOYEES

	The Educational Levels of Marketing Department Employees.															
? Employees:	**1999**								**2003**							
	Primary School Education		Secondary School Education		University Education		TOTAL:		Primary School Education		Secondary School Education		University Education		TOTAL:	
	Abs.	%	Abs.	%	Abs.	%	Abs.	%	Abs.	%	Abs.	%	Abs.	%	Abs.	%
0 - 19	1	5	8	40	11	55	20	100	1	6	7	44	8	50	16	100
20 - 49	0	0	7	58	5	42	12	100	0	0	6	50	6	50	12	100
50 - 249	0	0	9	32	19	68	28	100	0	0	8	27	22	73	30	100
250 and more	0	0	6	29	15	71	21	100	0	0	6	18	27	82	33	100
Sub-Total:	1	1	30	37	50	62	81	100	1	1	27	30	63	69	91	100

It is critically important that an enterprise establish the priorities for its marketing strategies in order to be able to achieve the set marketing aims and objectives. These strategies must be in a written form, in order to make it clear to all interested parties (employees), just what the final outcome of their endeavours is supposed to be. For this very reason, we asked each enterprise whether it had established a set of priorities for its marketing strategies and whether these priorities were in a written form. In cases where these priorities had been already established, we asked whether they had to do with traditional strategies that had been continuous for that enterprise for years, or whether they were newly thought-out, innovative due to new conditions facing that enterprise.

From both research studies viz. Tab. 5. it was clear that, for a majority of these enterprises, no clearly defined marketing strategies in a written form had been established. In the course of the four-year period in question though, we can see a certain growth in the numbers of enterprises in which such marketing strategies have been established and set out in a written form for all and sundry – but that this growth is only from the level of 23% of those questioned in 1999 to 37% in 2003, which would still seem to be insufficient (to us). Above all, it is in the Small Enterprises where such marketing strategies are not established – and which are most probably the consequence of the workload on the enterprise's proprietor(s), since these tend to assume all of the management roles, and in which the financial (payment) solvency question (i.e. debt-chasing/recovery) still means a not inconsiderable time burden on these small Czech enterprises.

For Medium-sized enterprise, no significant improvement was noted over the course of the two research studies. I n 1999, 57% of these enterprises had no marketing strategies; and by 2003, this was somewhat less – with 51%, but one cannot talk of a convincing change for the better!

For Large-scale Enterprise, there is a certain need to improve the quality of the performance of the marketing functions. However, it is still true to say that a majority of these enterprises still do not have clearly established marketing strategies. In 1999, 43% of such enterprises did not have their marketing strategies set out in a written form; by 2003, this had decreased to 32%. Despite the above, it is necessary to state that such a quantity of Large-scale Enterprises, still lacking clearly elaborated marketing strategies does not reflect well on the prevailingly (relatively) good situation for many of these Czech enterprises – and it would be worth considering their (chances of) success in the competitive conditions prevailing in the European and world marketplaces.

It is also interesting to look at the outcomes of this research study regarding the approach by these enterprises to marketing strategies in general. When comparing the two research studies over the course of the four years, it is possible to track a shift by these enterprises towards new marketing strategies, which react to the currently rapidly changing competitive environment (viz. Tab. 5.).

This change in marketing strategies from continuing (continuous or stable) traditional ones to strategies designed to react to changes in the marketing environment can be observed not only in small-scale enterprises, but also in the large-scale ones. It is only in the medium-large category that this trend cannot be observed. This can be associated to the fact that, as regards the low price-level of labour in the Czech Republic in comparison to other European countries, a great quantity of medium-large enterprises in the Czech Republic operate in the mechanical engineering and other production spheres and produce for foreign-based customers, whereas this is most often working for a daily wage. In truth, in connection to the ascension of the Czech Republic into the European Union in the middle of next year (2004), and where an increase in the price-level and a growth in the cost of labour is anticipated, this discovery does not bode well for, nor offer a positive perspective for these enterprises.

TABLE 5. CURRENT MARKETING STRATEGIES.

	Current Marketing Strategies.															
	1999								2003							
? Employees:	Not Clea Established:		Established Continuation Existing Traditional Strategies:		Established Well-thought out, Innovati		TOTAL:		Not Clea Established:		Established Continuation Existing Traditional Strategies:		Established Well-thought out, Innovati		TOTAL:	
	Abs.	%	Abs.	%	Abs.	%	Abs.	%	Abs.	%	Abs.	%	Abs.	%	Abs.	%
0 - 19	153	91	11	7	4	2	168	100	88	78	15	13	10	9	113	100
20 - 49	45	80	7	13	4	7	56	100	36	72	12	24	2	4	50	100
50 - 249	36	57	22	35	5	8	63	100	35	51	11	16	23	33	69	100
250 and more	16	43	13	35	8	22	37	100	14	32	17	38	13	30	44	100
Sub-Total:	250	77	53	17	21	6	324	100	173	63	55	20	48	17	276	100

An important precondition for maintaining one's position in this newly forming economic environment is the introduction and implementation of, as well as the degree of intensity of the exploitation of, the Internet as one of the main informational, but also communications channels. The Internet is becoming an indivisible component of marketing practice as a source of information about the entrepreneurial environment, customers, competitors, and is used above all for the promotion of enterprises.

The research study outcomes summarised in Tab. 6 demonstrate the exceptionally high number of Czech enterprises that have implemented the Internet into their working practices. Above all, it is interesting to note the significant growth in the number of enterprises connecting to the Internet over the course of 1999 to 2003. This growth is clear for all size categories. In 1999, 62% of the Czech enterprises questioned had a connection to the Internet, whereas now this figure has risen to 94%. The Internet has become an indivisible and essential component of everyday working practices (in the Czech Republic). One can talk about an unusually rapid acceptance of this new information and communication channel for Czech enterprises.

All of the medium-sized and large-scale enterprises tracked in the course of this study had introduced the exploitation of the possibilities offered by the Internet to their enterprises practices by 2003. Only 6% of small-scale enterprises with up to 49 employees did not have it available as an everyday tool. This is a very optimistic finding, which shows the very high level of informational and communicational level of Czech enterprises.

Overall, it is possible to say that, within the framework of the enterprises being tracked, it was discovered that 94% of all these enterprises use the Internet. If we compare these outcomes to the research study conducted by the OECD in 2001 in selected countries [c.f. OECD. Business-to-Consumer e-commerce Statistics, 2002], Czech enterprises rank themselves - in comparison to the rest of the world, among the most-developed countries. The

OECD Report indicates that the best-placed countries in which the Internet is exploited in enterprises with more than 10 employees are Finland and Sweden, where more than 90% of these enterprises use the Internet. In Canada and Great Britain, the statistics are only more than 60%, and in Austria the figure is over 80%.

TABLE 6. THE INTERNET IMPLEMENTATION IN CZECH ENTERPRISES.

	Internet Implementation in Czech Enterprises.											
? of Employees:	1999						2003					
	YES:		NO:		TOTAL:		YES:		NO:		TOTAL:	
	Abs.	%	Abs.	%	Abs.	%	Abs.	%	Abs.	%	Abs.	%
0 - 19	91	54	77	46	168	100	98	87	15	13	113	100
20 - 49	31	55	25	45	56	100	48	96	2	4	50	100
50 - 249	45	71	18	29	63	100	69	100	0	0	69	100
250 and more	34	92	3	8	37	100	44	100	0	0	44	100
Sub-Total:	201	62	123	38	324	100	259	94	17	6	276	100

The Internet is one of the most rapidly expanding and developing information and advertising media. Customers are ever-more-frequently using the Internet to acquire information about products as well as about those enterprises that offer them. The research study on these Czech enterprises was expanded in 2003 (as against 1999) by questions regarding their own company web pages. This differentiated question was missing in the 1999 research study, but the passage of four years has led us to believe that this question is a highly appropriate one, in view of a contemporary evaluation of the marketing activities of Czech enterprises.

An indivisible component of the findings in 2003 was whether or not Czech enterprises are prepared to deal with e-customers, whether they provide them with information about their enterprise, and just how capable they are in exploiting the Internet to sell their products. Tab. 7 captures how many of the Czech enterprises tracked in this study had their own web pages used to promote the enterprise in 2003, and investigated how many of these provided not only information about the enterprise, but also if it was possible to order the goods being promoted immediately, directly from these web pages.

Based on investigations conducted in 2003, it is possible to state that the majority of Czech enterprises have their own webpage(s), i.e. this holds true for 83% of these enterprises. Among those who do not have their own web page(s) are mainly the Very Small Enterprises with up to 20 employees, i.e. 31%. This obviously has to do with enterprises that operate on a local basis, and rely on their word-of-mouth reputation and advertising in the local print and radio media for their promotional efforts.

With medium-sized enterprises, it was discovered that 93% of these had created their own web page(s), and for large-scale enterprises the figure was 95%. As became clear from the research study, Czech enterprises for the time being still use their web pages largely for promotional purposes to present their businesses, in order to provide information about their activities – but that, to a lesser extent, they also have implemented direct e-ordering systems. 83% of these enterprises indicated that they have their own presentation on their own web pages, while only 23% indicated that they had actualised an electronic ordering system on their web pages.

These enterprises therefore still insufficiently exploit the full possibilities represented by the Internet, which is - of course, the direct and immediate possibility of realising the sale of an item being promoted on their web page(s).
However, if we compare the results obtained from our study with those of the OECD statistics, (i.e. the OECD Business-to-Consumer e-commerce Statistics, 2002), we discover that our enterprises rank among the quickest in implementing these new sales technologies. The OECD statistics show that 30% of enterprises with more than 10 employees in Holland, but only 7 % of those in Canada or 10 % in Austria are capable of taking orders over the Internet.

If we consider the results for Japanese enterprises in 2001 made public in the OECD statistics (i.e. OECD. The Latest Official Statistics on Electronic Commerce: A Focus on Consumers´ Internet Transactions. 2002), the number of Japanese enterprise capable of accepting order via the intermediary of the Internet is not quite 30 %.
It can therefore be said, that for the given comparison is very optimistic for Czech enterprises.

TABLE 7. PRESENTATION OF CZECH ENTERPRISE ON THEIR OWN WEB PAGES.

	Presentation of Czech Enterprises on Their Own Web Pages.							
? of Employe	2003							
	Own Web Pages – Used for Self-promot Only:		Own Web Pages – With Electronic Order Facility:		Do Not Have Own W Page:		TOTAL:	
	Abs.	%	Abs.	%	Abs.	%	Abs.	%
0 - 19	58	51	20	18	35	31	113	100
20 - 49	31	62	13	26	6	12	50	100
50 - 249	47	68	17	25	5	7	69	100
250 and more	29	66	13	29	2	5	44	100
Sub-Total:	165	60	63	23	48	17	276	100

Conclusion

The aim of this research study over the period of 1999 to 2003 was to provide an overview of the marketing activities in Czech enterprises. With a view to the past, in which a planned economy existed in the Czech Republic up until the end of 1989, and where Marketing, Product Promotion, and Consumer Demand, were neglected and in the given situation unneeded concepts, it has proved interesting to track the development of marketing activities in Czech enterprises.

Basing on both of the research studies, it is possible to provide answers and to respond to our hypotheses as set out at the beginning of this paper, as follows:

H1: Czech enterprises underestimate (the value of) Marketing activities.

This hypothesis has been confirmed, Czech enterprises continue to insufficiently assign a value to the benefits and advantages flowing from well-conceived and conducted marketing activities. The majority of these enterprises still lack an independently functioning Marketing Department. Where an independently functioning Marketing Department exists, this department is not directly subordinated to the management of the enterprise. These departments are often still predominantly staffed with employees with a Secondary School education level. A not particularly encouraging phenomenon is still not to be found in the domain of elaborating marketing strategies, where marketing strategies in a majority of the enterprises followed are clearly established nor are they in a written form.

H2: In the course of 1999 to 2003, a shift towards strengthening the significance of these marketing strategies in Czech enterprises occurred.

From the research conducted by us, it follows that a certain positive shift in the perception of the necessity for marketing activities in these enterprises has taken place in the course of 1999 to 2003. This hypothesis has therefore been partially confirmed. However, the question still remains, just how the given positive evolution will be sufficient to enable Czech enterprises in the future to stand up to the competition in a unified European or the world's marketplaces. It can be said that the given evolution is sufficiently apparent that it is possible to anticipate or presuppose the future continuation in this tendency in the direction of an increased significance being afforded to marketing practices in Czech enterprises.

H3: The introduction of the Internet into Czech enterprises has grown over the course of the period: 1999 to 2003.

Based on this research study, it is possible to accept unambiguously the given hypothesis. In the course of these two research studies, conducted in 1999 and 2003, a clearly apparent growth in the number of enterprises which are connected to the Internet and which exploit it in an everyday context in their daily activities. The Internet has thus become an integral and indivisible component of everyday working practices. All of the medium-sized and large-scale enterprises which took part in the research study in 2003 had implemented and integrated the Internet into their enterprise.

In a market-oriented, entrepreneurial environment, in which private ownership is given greater preference than state-ownership, and where neither production nor consumer demand are planned, Marketing-related activities have demonstrated their worth as highly useful, or even essential to an enterprise, simply in order for it to be able to maintain, or even improve its position on the market in comparison to its competitors.

Based on these two research studies conducted into Czech enterprises in the years between 1999 and 2003, it is possible to state that Czech enterprises still lack a sufficient awareness of the importance of the marketing function and those marketing activities associated with this function. A significant number of the enterprises underestimate the importance of Marketing, and often erroneously attribute a predominantly commercial role to it.

The Marketing function is still – traditionally undervalued. In a majority of the enterprises there is still no independent Marketing Department, and the employees of these Marketing Department are rarely directly subordinated to the Top Management of a Czech enterprise, since in the majority of cases they are still a part of the Sales Department. The educational level of employees in the Marketing Department is often at a Secondary School level. The majority of these enterprises still have not elaborated marketing strategies, nor do they have them set out in written form such that the corresponding employees would be able to identify themselves with these aims and objectives.

Despite the above, it is possible to track a certain positive shift over the course of the period covered by 1999 to 2003. An increase and improvement in the level of Marketing in these enterprises has occurred, and a tendency towards a shift in the perception of the importance of such departments (i.e. Marketing Department s) can be noted within the overall organisational structure – where, ever-more frequently, and this holds true predominantly for the large-scale enterprises, these are directly subordinated to the enterprise's Top Management. As regards the educational structures of Marketing Department employees, an increase in the share of university-educated employees has been noted in these Marketing Departments. From the perspective of the existence (or otherwise) of marketing strategies – it can be stated that it is possible to observe a positive growth trend in the number of enterprises that have seen the necessity for establishing a marketing strategy for themselves, and growth has also been noted in the number of new, innovative and well-thought out marketing strategies, reflecting the changes in the surrounding marketing environment.

As has been shown and on the basis of this research study, it fair to anticipate further improvements in the approach by Czech enterprises to the problems and issues associated with the Marketing function.

A pleasant surprise was the discovery that Czech enterprises are well placed as regards the domain of the existence and implementation and exploitation of the opportunities afforded by the Internet. The great majority of all enterprises tracked are already connected to the Internet, and conduct their own promotion by means of their own web pages.

Over the course of the years being tracked, i.e. from 1999 to 2003, a significant growth in the number of enterprises making use of the Internet in their everyday activities was noted. There was a significant increase in the number of Internet connections owned by Czech enterprises, while at the current time, all of the medium-sized and large-scale enterprises tracked, made use of the opportunities afforded by these communication and information-provision channels in their business activities.

The majority of the enterprises contacted in this study do not make use of electronic transaction systems in their business dealings. Overall, it can however be said, that Czech enterprises are on a comparable level with other economically-developed states in the world as regards the opportunities afforded by electronic commerce.

Czech enterprises continue to underestimate and value Marketing practices. The Czech Republic will become a member state of the European Union in mid-2004, and, as long as Czech enterprises want to maintain their share of the market and eventually, even to address customers hailing from all over the future unified European market, they should devote a lot more time and money to improving the quality of their Marketing activities, in order to better understand and know their potential future target customers.

Czech enterprises will have to place a greater emphasis on taking into account the European and even world dimensions given the enormous number of competitors, as well as to better know and understand the permeability of the market, the behaviour of customers and competitors and to factor all of these into their entrepreneurial strategies.

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The Rabbit and the Wallaby: Why the Quality of North American OEM – Supplier Relationships in the Automotive Industry Lags behind those of the Japanese Transplants

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Abstract

The North American automotive supplier industry is at a critical point in its evolutionary process as a do-or-die scenario presents itself, particularly with respect to smaller suppliers. For these manufacturers, the overall picture is bleak; prices remain under pressure due to excess global supply that is likely to worsen as production in China ramps up. With domestic automakers forced to cut prices in order to remain competitive in this increasingly price-sensitive market, North American suppliers must absorb much of the resulting profit squeeze. Hence, the failure or consolidation of a large number of North American suppliers is likely in the coming decade.

This paper explores the significance of the North American OEM-supplier relationship structure to this survival question. Despite efforts to eliminate the gap between the US OEMs and the Japanese transplants in terms of the quality of supplier relationship management, a significant deficiency remains. The pervading nature of this gap is explained through relating the evolution of the American and Japanese systems to that of a biological system.

The Automotive Industry as a Biological System

It will be shown that on some levels, the rapid integration of the Japanese OEM – supplier structural framework into North America mirrors the introduction of the feral European Rabbit oryctolagus cuniculus into the Australian continent by 19th century European settlers. An evolutionary biological framework when applied to the relationship structures present both in the North American traditional and the Japanese introduced systems, may aid our understanding as to why each system remains largely distinct. Considering the widely accepted notion that the Japanese system holds several key competitive advantages, the question turns to why the Japanese system has yet to be implemented in its totality by any one of the traditional Big Three automakers?

Through ascribing an organic nature to the industry, we may be better equipped to answer this question. The most generally accepted measurement of success in the natural world is reproduction and propagation of the species. In industry, the greatest measure of success might be somewhat more difficult to define, but if we take maximization of firm value as a starting point, we can move ahead with the analogy. Resources may be defined as those building blocks upon which the attainment of an end goal is founded. In nature, resources come down at the most basic level to energy, practically all of which was originally derived from the sun. In business, information is the most basic resource, the processing, transformation and translation of which creates value. The flow and associated riskiness of these information resources in the business world parallel the flow of energy resources in the natural world, providing an alternative means of competitive assessment to the strategic planning approach.

Relationship Efficiency

In nature, relationships may be crucial determinants of the ability not only to survive, but also to thrive, as efficiencies may be gained or lost depending on the methods of resource accumulation and processing employed. This is not only true within species (cooperation/competition), but also between different species as a form of symbiosis (mutualism/parasitism). Sharks with remoras, flowers with bees, and trees with squirrels, all involve a symbiotic pattern that results in mutual energy (resource) conservation, thus facilitating the diversion of more resources toward the furthering of the propagation end-goal. Relating symbiotic norms in the natural world to those of industry, we see that the same concepts may also apply. The Japanese have been lauded for their cooperative relationships with a different 'species,' namely their suppliers. What determines and affects symbiosis in nature may provide insight as to the nature of such relationships in the automotive sector.

Evolutionary Competition

With the Japanese transplant phenomenon introducing a fundamentally different type of organism into North America, the domestic manufacturers have been unable to effectively perform a most crucial function for survival, adaptation, at a fast enough pace. It will be demonstrated that even as the US manufacturers have implemented internal measures in an effort to match the dominant "species" (Toyota) in manufacturing, making the changes necessary for an adoption of the entire system, particularly supplier relations, has proven to be far more difficult. This can be tied to the complexity involved in replicating both a new external relational system, while concurrently adjusting the internal processes required to accommodate the information flows inherent to the new system. Even more critically, in all symbioses there are resource gains and losses, and it is often not immediately determinable where those gains and losses are located within the system. If we accept that in many cases the complexity of the system that is to be duplicated has emerged due to an evolutionary process, capturing and accounting for all the subtleties of these resource flows, external and internalized, in the laboratory-like setting of strategic planning is understandably difficult.

The current environment; pricing pressures and the incentive war

To understand any self-contained system or biotope in nature, it is first necessary to understand the state of the environment in which that system exists. It must be kept in mind however, as will be discussed further in later sections, an environment is constantly not only acting as a constraint to the evolutionary process and affecting it, but is also being affected by that which is contained within [Sapp, 1994, 197]. This is a crucial point as it helps us to realize the folly in assuming a simple or direct causal relationship between an environment and its inhabitants, when in all likelihood a far less linear and infinitely more complex one exists.

The overarching concern for the automotive industry as it stands today, at least from the sellers' perspective, is the glut of cars available for sale in the traditional markets. OEM global productive capacity, when defined as the designed-for output of all operable factories and support systems in the automotive sector, is currently estimated to be in excess of 90 million units, both cars and light trucks for 2003 [Truett and Crain, June 9, 2003, 40]. This figure is expected to grow significantly in 2004 and beyond as OEMs in China begin to ramp up domestic production. According to a recent KPMG study, China will produce 2.7 million vehicles in 2003, 900,000 more than domestic sales forecast. The bulk of this production stems from US, Japanese and European manufacturers partnering with Chinese producers in attempts to gain a foothold in what is anticipated to become a major automobile market in the coming decades. In the short-run however, excess domestic production is expected to climb to 2.3 million in only two years time, pointing to a net export of vehicles out of China and into more saturated markets [Brent, September 17, 2003, FP1]. Meanwhile, global sales totaled only 59,587,416 units in 2002, representing an approximate 66% average utilization rate of assembly assets in place across the major car manufacturers [Automotive News, 2003 Market Data Book]. In North America alone, excess capacity is expected to top three million in 2003 [Wilson, January 20, 2003, 14]. With stagnating demand growth in the traditional markets, this excess capacity can be dealt with in one of two ways. The automakers may reduce productive output to meet demand at previous price levels through reducing their asset utilization further, or reduce prices in order to maintain or increase sales.

This choice between two basic supply and demand alternatives has driven much of the current market's strategic focus over the past few years. With an abundance of competing automakers vying for customers through largely undifferentiated offerings, the price elasticity of demand is high for most mass-market model segments, and increasingly so even for niche market vehicles. The result of this price sensitivity and the selection by OEMs of the latter alternative of boosting volume at the expense of margins is that price incentives have driven a significant portion of sales growth over the recent down cycle. The mispricing of a model relative to current demand during such intense price competition can have disastrous consequences, and was likely the cause for the failing of Ford's Thunderbird revival. Intended to sell in excess of 25,000 vehicles per year but selling only 19,085 in 2002, the $35,495 sticker price appears to have been a significant factor in its lackluster sales and subsequent cancellation after the 2005 model year [Wilson, March 31, 2003]. Competing against other new models such as Nissan's 350Z, priced thousands less, Ford was unable to convince customers to fork out the extra funds necessary without turning once more to incentives on what was to be a "flag ship" product that initially sold at a premium to sticker.

General Motors has led the aptly coined "incentive war" through leveraging its current status as low cost producer in the US [Guilford, August 18, 2003, 1]. For General Motors, this may be less a war than a trouncing, as Chrysler and Ford have had their strategic hands forced. GM as the lowest cost producer of the traditional big three, largely due to its effective implementation of Japanese manufacturing principles, may be able to price Chrysler and Ford right out of profitability. "GM's going to be the only one of the Big Three who makes any decent money," with Chrysler and Ford now forced to compete on GM's pricing terms due to their recognition that because of manufacturing and union cost structures present, greater losses may be incurred through the idling of productive resources and losing market share than through accepting losses at volume [Content, December 29, 2002]. Unfortunately for GM, it is still not performing up to par with Toyota, Honda and Nissan, and with legacy costs from pension and health care liabilities looming large on the horizon, it may not be performing up to par for its own long-term viability.

Supplier Impact

Profit squeeze

As competition intensifies, suppliers are increasingly being called upon by their OEM customers to reduce prices on components and module systems. On average, approximately 50% of vehicle costs are outsourced to suppliers [Snyder, April 7, 2003, 22 and Fitzgerald August 1, 2003, 46], making them a prime target for North American OEMs that are otherwise constrained in their cost cutting options by UAW agreements [Kurylko, August 11, 2003, 1]. What's more, OEM – supplier contracts stipulate annual price reductions. In January 2001, Chrysler requested 5% price reductions from all its suppliers. More recently the struggling OEM has looked for a further 10% reduction across its supplier base, asking many suppliers to match prices in low-wage nations such as China [Sherefkin, June 16, 2003, 1].

Large tier one suppliers such as Magna International, component parts and module manufacturers that sell the bulk of their product directly to the OEMs, are in more enviable positions than most. Those that provide complete module solutions are better situated to negotiate and even refuse to commit to many cost cutting demands, particularly when diversified across a wide customer base. Magna has substantial negotiating power furthered by its growing stake in terms of content per vehicle in North America, contributing on average $441 in 2002 to the OEM cost of production for a new vehicle, and expecting that to grow to $520 for 2003 [Brent, August 7, 2003, FP6].

Tier one suppliers often look to tier two suppliers to carry a large part of the cost cutting burden that is dictated at the OEM level. These first tier suppliers are searching for ways to satisfy cost cutting imposed by their Big Three customers, and are finding that a consolidation of their own tier two and tier three supplier base is a necessary first step. Both Visteon and Delphi have indicated this year that they are looking to dramatically reduce their supplier base [Zachary, April 1, 2003, 4]. It is therefore the small and medium sized suppliers that will continue to suffer most from price competition and overcapacity. In spite of these poor conditions there are suppliers, both large tier 1's and specialized niche players, who have succeeded in the past decade. A study of 43 publicly traded North American suppliers found that while the median supplier has seen their profitability fall by 50 percent, top suppliers have increased their margins by 75 percent over the period 1992 to 2001 [Autoparts Report, July 3, 2002], reflecting a polarization in profitability and competitiveness. Some predict it is likely that half of the current tier 1 and tier 2 suppliers will be out of business in 10 years, and that 47 % of North American suppliers are currently in "fiscal danger" compared to 36% of Asian suppliers [Truett and Crain, June 9, 2003, 40]. Whether these figures include supplier consolidation is not clear, but the ominous tone of such a study, representative of many similar ones that call for massive failures within the industry, should be a cause for alarm in itself, as it is likely symptomatic of the North American domestic manufacturing industry. In fact, one of the greatest concerns to the Japanese may be the impact of US OEM's price pressure on shared suppliers. According to a supplier executive, Toyota had called in AlixPartners a financial troubleshooting firm, to look into some suppliers that it shares with Ford and GM to ensure that they were not in financial trouble [Sherefkin and Wilson, February 10, 2003, 6].

The Japanese: thriving in a harsh environment

Of particular interest to our analysis is how the Japanese OEMs have managed to cope with a weakened North American market demand. Thus far in 2003, the Japanese producers have employed average incentives of $1,062 per vehicle, the Korean manufacturers $1,371 and the Europeans $1,945, all while continuing to capture North American market share away from the Big Three whose own incentives average $3,389 per unit. These incentives have cost US automakers dearly in terms of profitability per vehicle vis-à-vis their Japanese counterparts, with Nissan and Toyota earning $2,069 and $1,214 respectively while GM earns $701 and Chrysler a paltry $226 on each vehicle sold [Priddle and Zoia, August 1, 2003, 8].

The future environment does not appear to be any rosier in terms of competitive pressures and overcapacity issues in either North America or globally. Renault is moving ahead with planned factory expansions that will see an additional capacity of 600,000 vehicles per annum in Europe [Johnson, November 18, 2002, 20]. China has been cited as another problem area as the potential exists for substantial export capacity into a global arena that is already flooded. According to a survey conducted by AlixPartners, global excess capacity may top 42 million by 2010 [Truett and Crain, June 9, 2003, 40]. The potential saving grace would be an expansion of the developing markets of China, India, Eastern Europe and South America. Goldman Sachs has recently come out with economic projections for Brazil, Russia, India and China (BRIC) predicting that by 2040, all of the 'BRIC' countries individually will overtake Germany in GDP, with China's GDP exceeding that of the United States by 2045 [Thorpe, October 3, 2003, IN1-FP4]. Such a scenario would certainly improve automotive sales growth prospects, as consumption would increase commensurate with income. However, the question then becomes how many North American suppliers, and indeed some of the OEMs themselves will still be viable companies in even the shorter-term of 10 to 20 years.

Relationship Structures

Given this hyper competitive environment, what is the prevailing sentiment between suppliers and their OEM customers? A survey by Planning Perspectives released earlier this year highlighted the growing divide in terms of satisfaction, between the North American suppliers and their OEM counterparts. The Japanese OEMs once more received praise while US OEMs were blasted for their pricing pressures and short-term business loyalties. In the survey, approximately one third of respondents said that their companies no longer provide Big Three OEMs their best technologies, and when asked if they could foresee a time when their company no longer did business with the Big Three, 17.6% responded in the affirmative [Murphy, August 1, 2003, 8]. Our own supplier survey, which is ongoing and not yet of sufficient scope to warrant quantitative inclusion, shows preliminary indications that supports this conclusion, with suppliers indicating that there are significant elements of trust lacking in their relationships with US based OEMs. One owner of a small Canadian supplier with annual sales in the $50m+ range completed the general portion of our survey but indicated that he was unable to complete a series of customer-specific questions. He did however convey the following thoughts:

> "I have not filled out the Customer Option section. My reason for not doing so is that our top customers in the OE area are Japanese and they believe in building relationships with their suppliers on the basis of mutual trust and respect. It is unfortunate, but the same cannot be said of the North American manufacturers."

The above statement appears to be indicative of the current state of affairs in the relations between the majority of suppliers, and the American OEMs. The following is a brief overview of the two distinct systems of supplier relationship structures, Japanese and American. Between the two systems there are a number of substantive issues that underlie the overall relationship linkages and norms in place.

Adversarial & Cooperative Systems Compared

US OEM-supplier relationships have often been described us being set in an "us versus them" framework. The fundamental principles of free market price competition would likely be cited as the philosophical basis of the system as a whole, with a liquid and rather homogenous pool of suppliers as viewed from the perspective of big three purchasing managers, making substitution from one contract to another the norm rather than the exception.

The Japanese on the other hand are touted as being far more cooperative and accommodating to supplier needs. Following below is a summary exploration of these tendencies.

Price pressure versus assistance

The Japanese and American OEMs differ in the means by which they attain their respective cost targets. Both apply some level of pressure to their suppliers in order to meet these targets, and both groups expect high levels of conformity to projected costs. The American OEMs are viewed by suppliers as being more rigid, demanding and less helpful in meeting targets, with the final price being the end determinant of the relationship's quality. "The Big 3 are quick to beat down prices with methods such as electronic auctions or rebidding work to a competitor." The Japanese on the other hand, are portrayed by most suppliers as being more flexible in situations where price targets are not met, and will act to assist suppliers in meeting goals. "The Japanese are equally tough on prices but are committed to maintaining supplier continuity" and when price targets are not met "both sides look for savings" [Sherefkin and Wilson, February 10, 2003, 6].

Quality demands versus solutions

Similar in concept to the price pressure versus cost assistance framework, is the quality demands versus solutions framework. The Japanese appear to be far more willing to accept the short-term investment of sending engineers in to assist a supplier in meeting quality goals and targets, looking for a solution with the supplier rather than merely imposing demands. The Big Three continue to press with price cut and productivity demands, often in a confrontational manner, increasing the possibility that quality will be impacted, particularly as less competitive suppliers try to hang on to survival through cutting corners in materials and component quality [Henke, March 2002].

Competitive bidding versus long-term relationships

With the free market process being the underpinning of the US OEM supplier relationship philosophy, it is therefore not surprising that the bidding process is similarly free market based. The bidding process looks to determine the absolute low cost provider of a solution, given the constraints of quality and function as determined by the manufacturer. Unfortunately, a potential error in such apparently quantitative (and misleadingly "hard") methods of best-provider determination is that the entire cost is likely not reflected. The result is a market failure due to lack of inclusion of all indirect costs, resulting in a decision that is based on too narrow a scope of factors. This may explain why the Japanese may value an incumbent bidder more highly due to what may have traditionally been deemed as subjective criteria by US managers.

These subjective considerations however, particularly regarding trust, may have merit as significant sources of cost advantage and savings if assessed in a holistic context [Dyer and Chu, Summer 2000, 259]. The result is that the US OEMs may undervalue incumbents or those companies that offer "soft" advantages, too eagerly pursuing a short-term cost advantage that even when assessed in present value terms and weightings, is not sufficient to account for the lost "soft" values attributable to lower transaction costs, increased investment expenditures, and greater learning that long term relationships may foster. Honda's facilitation of strong long-term relationships and supplier assistance is not a selfless act. Robert Schuld, senior staff administrator for supplier support, explains that Honda's assistance is intended to "strengthen supplier business operations to a level of competitiveness consistent with their needs as well as our own" [Zachary, July 1, 2003, 7]. It may be gathered then from Honda's historically strong margins and profitability, along with consistently high rankings in supplier relations surveys, that such assistance has been mutually advantageous.

Results, Reactions & Implications

The result of these very different approaches toward supplier management by the US and Japanese OEMs is that there are several key areas in which suppliers have reacted or are beginning to react. This reaction may be due to the recognition of the dire consequences of failing to change, or may be to exploit the Japanese' continued market share gains in North America.

Diversification of customer base

The first step that many suppliers are taking as a reaction to both the reality of declining US OEM market share and the continued adversarial posturing of the Big Three is to attempt to diversify their customer base. Most small and medium size suppliers in North America are over weighted in sales to the Big Three and under-weighted in transplant manufacturers. An argument can be made that in order to be effectively diversified, a supplier should have customers sales that reflect market share. With US OEM North American market share falling below 60% for the first time in history this year, it is an indicator that suppliers should not have more than 60% of their domestic business reliant on Big Three customers [Brent, October 1, 2003, FP1-FP9]. The urgency of diversification is compounded by projections that have foreign-based manufacturers continuing to capture market share away from the Big Three in what is now a slow growth market. For suppliers to grow themselves then, they must either look to capturing a percentage of the growing transplant market, or will otherwise need to pursue their growth opportunities through acquiring market share directly from competitors [Fitzgerald, April 2002, 34-36]. As industry consultant Kim Korth put it at a management briefing seminar to supplier executives, "you have the fiduciary responsibility to your organization to aggressively try to diversify your customer base" [Kisiel, August 11, 2003, 21].

Unfortunately, the advice of diversifying one's customer base is not easy to heed in practice, as the majority of small to medium suppliers (85%) currently have domestic (US OEM) customer concentration of 90% or greater [Fitzgerald, April 2002, 34-36]. Due to the long-term nature of Japanese OEM – supplier relationships, it is not easy for a small supplier to break into a Japanese supplier circle, particularly after having been weakened through price pressures from domestic OEMs. For those companies that are specialized enough, however, or offer a significant advantage that may be marketed to the Japanese OEMs, this route is very appealing. It not only diversifies away much of the price and transaction risk associated with being concentrated in domestic OEMs, but it also allows suppliers to grow sales by targeting companies that are experiencing growth themselves, thereby obtaining a piece of a growing rather than shrinking pie.

It is also interesting to note that from a resource cost point of view, changing over a customer base, particularly when that customer accounts for a substantial portion of revenue, is highly risky and therefore holds substantial costs. That so many top suppliers are attempting the switch indicates that there must be some sort of benefit beyond the initial dollars and cents that are dictated by a solely quantitative approach. Perhaps it is the cost of not making the switch and being over concentrated that is helping push this trend, as reliance on a single customer in decline is the nightmare scenario. Visteon knows this scenario all to well as it attempts to reduce its dependence on Ford, a company on which 81% of Visteon's business was based in 2002, and a company that is losing market share in North America to the Japanese [Phelan, November 6, 2002]. Magna on the other hand "is getting more business from offshore-based auto makers operating in North America" as they recognize the growth of these foreign auto makers' market share at the expense of the Big Three [Alphen, August 7, 2003, D01].

Reduction of capital investment

Unfortunately, the route that most suppliers have taken and are likely to take into the future is the path of least resistance; reducing capital investment. When OEMs continue to place price pressures on small suppliers without providing adequate assistance or assurances of continued business, innovation is a secondary concern to survival. When faced with two "hard" constraints, one being price, the other being a defined level of quality, in combination with the necessity of securing a contract for short-term liquidity, most suppliers are opting to reduce long-term investments. As this quick fix becomes a commonly used technique to bolster anemic margins across the industry, a weakening of innovative capacity would be the logical conclusion. This will negatively affect not only suppliers, but in turn, also the OEM manufacturers that rely on innovative supplier offerings to remain competitive against foreign competition. Foreign manufacturers such as Toyota and Honda on the other hand "understand that tomorrow's differentiation and component quality are their tickets to maintaining strong margins and bolstering their marketplace image," and therefore make it a priority to ensure that their suppliers are in a position to make the capital investments necessary to innovate [Robinet, September 1, 2002, 40]. This, compared with supplier sentiment towards North American OEMs that blames reduced capital expenditures on the fact that "the carmakers are unwilling to share in suppliers' significant research and development costs" according to John Plant, President and CEO of TRW Automotive [Content, August 7, 2003].

Withholding technologies and refusing low margin contracts

These scenarios of reduced capital investment and heightened price pressures are indeed prevailing realities for many small and medium sized suppliers, who in order to survive, must accept the status quo alternatives however painful they may be financially. If they are unable to find new customers in the Japanese or European "new domestics," options are limited to making do as suppliers to The Big Three or falling into bankruptcy through the loss of contracts. For those companies that are more financially stable, however, there are a couple of additional options with which they can attempt to fight back. The first (as previously mentioned) is the withholding of top technological innovations from North American customers. That is, as price pressures become unrealistic, or adequate assistance and commitment is not forthcoming, some suppliers may choose not to offer their top technologies to Big Three customers, reserving those technologies for their Japanese clients instead. This has unfortunately become a trend that appears to be catching on, with suppliers indicating in recent surveys their greater willingness to share innovation with the Japanese transplants over the Big Three [Murphy, July 1, 2003, 7]. Lack of trust is considered to be a key determinant to this issue, as is the greater business risk in engaging in R&D expenditures with a Big Three client that may or may not continue business over a long enough time frame for the supplier to amortize the often considerable investments required for their most innovative products.

A most extreme example of withholding technology is the outright refusal to bid on contract work with American OEMs due to their supplier treatment and pricing demands, even as an incumbent bidder. The justification being that the expected returns of dealing with a North American OEM is not high enough to support investment, citing basic net present value financial principles. An example of such a situation recently occurred where Tower Automotive Inc., a supplier of frames, withdrew from negotiations with Ford for the Ford Explorer despite their strong position as an incumbent supplier of the current model. CEO Dug Campbell cited the fact that "expected returns at targeted pricing levels did not meet our requirements" as the source of the move, and indicated on top of this that had Tower developed any great ideas for the Explorer frame, it would not be sharing those ideas with Ford. Tony Brown, Ford VP global purchasing "admits his company is a long way from its goal of becoming the 'customer of choice' for its suppliers" [Murphy, July 1, 2003, 7]. Unfortunately for the Big Three, it is not only a matter of being customer of choice, it is also a question for some suppliers as to whether the Big Three should remain customers at all.

One of the main considerations and indeed restraints on the ability for suppliers to withhold technology or refuse contracts on the basis of poor margins is the need to amortize high levels of capital investment across a large income pool. If at the margin the investment does not appear all that attractive, the decision must then be driven as to the total average effect against ongoing capital expenditures. If the additional profit stream helps bring productive resources closer to their capacity, then the average cost of production will be reduced as assets are depreciated across a higher income figure. There are limits to such an approach, as the marginal output produced must remain profitable on a per unit basis to justify this absorption of fixed costs, but so long as this remains true, the auto parts suppliers may benefit from even low margin contracts.

Increasing market power

Another possibility, and one that has indeed become a reality of late in the automotive supply sector, is to improve margins through increasing market power. The focus of this in relation to the current situation between North American suppliers and their OEMs, is the strengthening of a company's position in negotiation. Through consolidating into larger and larger companies that contribute to a greater proportion of an automobile's value, the ability of the supplier to extract a fair value for their product is improved substantially. Michael Burwell of PricewaterhouseCoopers' estimates that the number of tier 1 suppliers will fall from about 600 in 2002 to less than 35 in 2010, while tier 2 suppliers fall in number from about 9,500 in 2002 to 800 in 2010, largely due to sector consolidation [Harrison, June 2002, 18-19]. With the strengthening of tier 1 suppliers' ability to control the supply chain and reduction of unit costs through increased scale, the ability of automakers to use price competition against such a supplier is reduced.

Application of an Organic Framework of Analysis

Having explained some of the environmental and situational constraints present within the automotive sector and how they relate to the competitiveness of North American suppliers, we may return to the question of why this gap in the quality of relationship management persists. The significant advantages that the Japanese displayed in manufacturing prowess in the 1980s through both their Japanese and transplant operations are well known today.

The traditional Big Three realizing this have taken great strides in bringing manufacturing efficiency and product quality up to levels that now approach those of the Japanese. So why then are effective supplier relations apparently so elusive? The key may come down to the evolutionary process responsible for the Japanese versus the American supplier system, and the entirely different symbiotic structures that they have spawned.

The Rabbit and the Wallaby: an analogy of evolutionary system convergence

An analogy that may shed some light on the difficulty of playing evolutionary "catch up" is that of the introduction of the feral rabbit oryctolagus cuniculus into Australia in 1858. Prior to 1858, the herbivore population of Australia consisted primarily of the marsupial class (kangaroos, wallabies, wombats) and a variety of lower organisms. The introduction of oryctolagus cuniculus into wild Australia placed a herbivore with different grazing habits and reproductive capacity into an environment with few natural predators or limitations on resource accumulation, and therefore few constraints on its population growth. The introduction had disastrous consequences for indigenous species. Most obvious on the surface and immediately recognizable, was the direct competition that the rabbit posed for resources such as food. Somewhat less direct consequences included the destruction of habitat through excessive grazing on certain plant species that resulted in the erosion of land areas, and therefore the subsequent destruction of other plant species, many of which were essential for the survival of other herbivore species.

Indirect consequences however, are what highlight the complex nature of relationship structures, and their ability to have enormous impacts on the totality of a biological or even industrial system. The introduction of the rabbit, which coincided generally with the introduction of cat and dog populations, produced a new symbiotic structure for these introduced animals as well as the indigenous species. Although mutually beneficial effects did not take place on the individual relationship level between these species, which was one of phagotrophic predation, mutual benefit did take place in their interaction as part of the newly altered system. The dogs and cats controlled and maintained a healthy rabbit population through the culling of the sick, while growing their own population through utilizing these rabbits as convenient sources of food. When disease did grip the rabbit population, these carnivore populations, otherwise sustained by the rabbits, would then turn to indigenous species. The sum result is that feral rabbits now cover 4.5 million square kilometers of Australia, as do their imported predators, while indigenous species have fared far worse, with many such as the wallaby, on the endangered list if not wiped out entirely [Data from Australia's Parks and National Wildlife Services].

What is apparent from the introduction of Japanese manufacturing transplants into North America is that while a similar version of symbiotic restructuring took place involving resource gainers, losers and the alteration of the environment, the resulting consequences were distinctly positive. Prior to the entrance of Japanese transplants, which themselves were stimulated toward entry by the Voluntary Export Restraints of the early 1980s, there was a general complacency amongst the Big Three. Acting in relational manner that may best be described as parasitic in nature, the Big Three formed an oligopoly that extracted resource gains through reduced investment, innovation and quality, with the resource losers being consumers. Post transplant introduction, the new symbiotic structure introduced was largely mutualistic in form, with resource gainers being end customers as well as those suppliers that were able to internalize themselves as part of the new system as suppliers to the Japanese. Although the end result was that of a fundamental alteration of both the players and environment, the economic benefits to North America most certainly outweighed the costs.

Impact of new industry paradigm on domestic OEM-supplier relations

More specifically, how does this tie into OEM-supplier relationships in North America? It introduces two primary themes. First, the notion that evolutionary biology displays cases where if two distinct systems are isolated, and then introduced, the natural process of selection is largely bypassed, and this new competition will result in an unbalanced scenario where coincidental previous adaptations on the part of the introduced species can wreak havoc on the indigenous species. Second, evolutionary traits that encompass a unique system of relations within an environment may not be passive in their effect on the environment, but are in fact likely to have a significant impact. The rabbits introduced to Australia were not only direct competitors for food within the environment, but also altered the environment in such a way that was detrimental to the survival of indigenous species. Further, their predator-prey relationship with dogs and cats created a situation that adversely affected the previous balance within the system. The intricacies and unexpected impacts of such small changes to a large and diverse biotope as that of Australia, underline the difficulty in accurately assessing relationship structures of very complex systems that experience the introduction of complex elements, as has been the case in the automotive industry in North America over the past two decades.

The Japanese transplant operations when they took root in North America not only setup their own structures, but also had a significant impact on existing relationship structures within the USA. Their unique symbiotic nature vis-à-vis suppliers not only benefits them directly through more efficient and effective total production quality, but also negatively impacts on US OEMs and their ability to compete for supplier business. At the same time, the OEM-consumer dynamic is altered as consumers have the additional choice of Japanese-made products that were soon to offer superior quality at comparable price levels. As suppliers gain the option of dealing with the Japanese, the US OEMs, having previously held a monopoly on supplier relationship ideals, must now contend with an introduced ethos that better equips suppliers to effectively cope, if not thrive, in the current environment. It is no great wonder then that the US manufacturers have had such a difficult time adapting to such concurrent changes. With the loss of oligopoly gains from passing costs down to end consumers, the burden of making up the efficiency gap with the Japanese and maintaining profits was placed squarely on the backs of suppliers unable or unwilling to make the switch to supplying Japanese customers. The way in which this gap is being partially bridged is through the increased price pressures placed on suppliers, as well as the reduced levels of profit being experienced by the US OEMs themselves.

Attempting to emulate an evolutionary process through strategic implementations

Unfortunately for US OEMs, the nature of the structure of the entire relationship structure is not as simplistic as that of the basic manufacturing system that they have to a great extent successfully duplicated over the past two decades. Rather, it is the sum of the processes incorporated in Japanese OEM business practices due to what Takahiro Fujimoto describes as evolutionary learning. This learning has for the most part occurred in a foreign company environment, and is nearly impossible to relate to in the context of a North American company. This is not to say that the concepts inherent in the Japanese system are superior independent of environmental context. Rather, the evolutionary traits that these companies have acquired in Japan have produced a system that functions more effectively in the current competitive environment.

The complexity of the structure stems from the complexity of a total relational system, which must include both internalized and externalized interactive routines. While the US manufacturers may have attempted to apply some of the internalized routines of the Japanese in terms of kaizen, kanban etc, they have either failed to recognize the extent of the internalization of processes that they currently view as external to their own system, or have failed to adopt externalized measures that may effectively produce the same results through their own implementation version.

One example of a relational structure that was implemented by the US with great apparent success is JIT (Just-in time) or kanban. Reducing inventory-holding costs for the manufacturers, the eventual successful adoption of JIT has been used not only in the automotive industry, but also telecommunications and many other sectors. While the rewards are apparent in terms of explicit holding and store costs to the manufacturers, there does appear to be a rather frightening limitation. That is, the imposition of JIT requirements on suppliers was done on the basis of demands rather than cooperative assistance. Suppliers therefore had to bear a large portion of the costs, and indeed in many instances held excess inventory levels in order to satisfy the demand requirements of their OEM customers. As the US OEMs were virtual monopolies with respect to their customers at the time of initial implementation, there was little in the way of effective protesting of such arrangements. However, it could be considered to be a sure bet that these customers were not delighted with JIT, leading to the potential for a zero sum gain in total economic efficiency in at least the initial implementation of the system.

The Evolution of Japan's Competitive Framework: Impact on Symbiotic Patterns of Development

With the US automakers effectively removed from the Japanese automotive market in 1936 by the Automobile Enterprise Manufacturing Law, the Japanese began to setup a more independent domestic automotive industry. With most suppliers lacking expertise in parts engineering, the level of engineering assistance provided had to be significant if the Japanese were to avoid the usage of only imported supplier parts or full in-house manufactured systems. This, perhaps in combination with cultural norms in Japan, aided the development of a system that included a great deal of interaction between OEM and supplier. This was in contrast to the US system, where the slower, more evenly paced buildup of the industry allowed suppliers to progress technologically at about the same rate as manufacturers, leading to the far more independent structure of relationships present up until this day.

We may also learn more about the evolutionary process of competitive practices through specific cases of system development. Takahiro Fujimoto uses the development of the black box parts system by Toyota and Nissan suppliers as a test for his general hypothesis of system emergence and learning capabilities. Within this study, he concludes that the black box parts system emerged "not because of rational calculation by the automobile companies, but because of a set of constraints or historical imperatives imposed on the automakers" [Fujimoto, 1999, 167]. The emergence of such a system through an evolutionary process is a key indicator as to how Japan's symbiotic relationship practices have developed. The black box parts system according to Fujimoto, was the result of an evolutionary process that was not based primarily on strategic implementation by Toyota, but rather evolved as a species would, through trial and error. In the case of the black box parts system, this random evolutionary process began with the separation of Nippondenso from Toyota in 1949, due to a loss at the electric parts factory and a restoration plan submitted by Toyota to the Japanese government. With the separation of the electric parts factory also came the movement of the electric component engineers from Toyota to Nippondenso, providing the setting for a black box parts system to come into being. Shortly thereafter, as Nippondenso began to supply Honda, Mitsubishi and Mazda, the system became diffused throughout Japan. These divergent evolutionary frameworks and histories are what led to two very distinct systems of relational structures, both internal and external. We will now turn our attention to the symbiotic structures that reflect these historical developments and their impact on competitive advantage.

Symbioses: An Overview

The term symbiosis has a rather clouded meaning in modern language, and it is often misinterpreted as "a beneficial relationship." Symbiosis more accurately defines any form of relationship in which two different species correlate or co-inhabit in some manner or form. The three general forms of symbiosis are:

Commensalism: The symbiote gains while the host is unaffected. (+/0)

Mutualism: Both symbiote and host gain. (+/+)

Parasitism: The symbiote gains while the host is negatively impacted.(+/-)

For the purpose of this paper and the economic analogy used, the host-symbiote relationship will be defined based on market power, with the designated host holding less power. This is reflective of the logic that the symbiote selects a host, and not vice versa. OEMs will be regarded as having greater market power than suppliers as a general rule, due to the greater number of suppliers from which OEMs may source their parts.

More importantly, it is critical to recognize that in all symbiotic relationships, there are resource costs that must go along with any benefits enjoyed. As indicated earlier, the difficulty in assessing the location of both direct and indirect costs and benefits may be key to explaining why it is that the US manufacturers have had such a difficult time in replicating the system.

Mutualism and the Japanese way

The Japanese OEM's history has fostered a symbiotic relationship between manufacturers and suppliers that resembles that of mutualism. Information flows both ways, not only from supplier to manufacturer, but also from manufacturer to supplier. The entire system process is heavily internalized with a great deal of reliance and trust between the OEMs and tier one suppliers.

Mutualism in nature calls for an increase in potential fitness on both sides of a relationship structure [Boucher, 1985, 30]. Fitness is seen as the productive usage of resources toward the end goal of procreation, or in the case of our industry analogy, firm value. Firm value is a measure of the summation of all future expected cash flows discounted at an appropriate rate of return that depends on the expected riskiness of those cash flows. If a mutualism-based relationship can act to increase the rate of expected cash flows at a greater relative rate than any increase in the riskiness of those cash flows, or alternatively decrease the risk without a correspondingly equivalent decrease in expected flows, it can be seen as increasing the fitness of the participant. If both participants increase their fitness through the engagement of such a relationship system, we can describe this symbiosis as mutualistic in nature. One such example of cooperation in an area that is traditionally viewed as adversarial or competitive is logistics transportation. Steve Sturm, VP and general manager of Toyota Logistics Services explains:

> "We treat our transportation companies as partners so that we work as a team. A lot of companies treat their transportation companies or whoever their source is as vendors and it's all about cost and every year you have to cut your cost more. The rolls are adversarial at best. We took a different approach. We work with them and when the good times are there, we both reap the rewards. When the challenges are there, they step-up and protect our business plan and also come to our aide when we need it and vice versa. When they struggle, we protect their business plan." [Haight, August 2003, 24-28]

The components of the Japanese system are discussed when combined as a whole act to reduce the uncertainty of cash flows to the supplier base through the engagement of longer-term relationships. Suppliers in turn are able to increase their investments in productive assets, benefiting their OEM customers through higher quality parts, innovation, and supply stability. This reduction in the risk profiles of both suppliers and OEMs is expected to reduce required rates of return on investment for shareholders, thus increasing firm value. Additionally, higher future growth may be anticipated from this cooperation, as consumers recognize and value the increased quality of product that such an arrangement produces. On the OEM side it is readily apparent where shareholder value has been created and where it has been destroyed, as Toyota, Honda and Nissan have seen their market values increase, while Ford and General Motors have witnessed a drastic fall in market capitalization. A possible area of future study would be to determine the correlation between customer diversification amongst suppliers and their market capitalization.

Parasitism and the American OEM – supplier relationship structure

The US evolutionary path has not required there to be the level of interaction between supplier and manufacturer that is present in the Japanese model. This theoretically makes for excellent flexibility and diversification, as investments can be moved amongst a wide number of potential suppliers or hosts from which value and information may be extracted. The short-term nature of the relationships also acts to reduce the risk of mispricing resources. This is particularly true when the relationship is relatively monopsonistic and the OEM has the ability to select the most cost efficient suppliers from which to source its components.

Unfortunately, this setup increases the risk to suppliers of making long-term, strategic investments, as contractual uncertainty prevails and undermines future cash flow expectations. Effectively, the situation has OEMs selling their assembled products to a relatively low risk pool of customers, while further reducing their own business risk in terms of supplier sourcing commitments. Suppliers, particularly those with business concentrated in the Big Three, have a very risky and price sensitive customer (the OEM), and yet in order to innovate must make large, long-term capital investments. The result is a lopsided risk/return profile for suppliers in comparison to OEMs; there is little guarantee in being able to amortize capital expenditures across time if contracts are short and continued business uncertain. When faced with only US OEM customers, as was the case prior to the early 1980s, this lack of choice clearly reflects a parasite-host symbiotic system where the Big Three OEMs successfully leveraged their oligopolistic position to extract value.

This parasitic relationship structure worked well for the OEMs prior to foreign competition shaking up the domestic market and permanently altering the environmental landscape. Ford's famous Pinto calculation that weighed law suits against recall costs demonstrated the type of extreme parasitic structure that existed for years in the ranks of The Big Three. The introduction of transplant operations in the 1980s from the likes of Honda and Toyota was the catalyst toward competition on the basis of product quality, making supplier innovation a key component to success. However, the previous parasitic structure that was so effective for the domestic OEMs during their oligopolistic heyday persists in basic form right up until today. The resulting emphasis on price has meant that "supply chain members are earning substantially lower returns than required to retain risk capital in their business over the long-term," which is at the root of many of the credit failures of North American suppliers today [Fitzgerald, November 2002, 40-42].

Genetic Traits of Mutualism

Slow evolution:
In order to maintain the most efficient exchange of resources, evolution in a mutualistic environment is expected to be relatively slow in order to retain compatibility between host and symbiote [Boucher, 1985, 151]. Toyota has demonstrated this tendency in practice, only implementing procedures and materials after they are certain to be easily adopted into the Toyota system without great interruption or sacrifice in quality. The most recent test of a new system came about when Toyota opened up their system to the testing of module component systems, something that they had previously avoided doing [Treece, February 18, 2002, 3].

Adaptability:
Organisms that employ mutualistic tendencies spread more readily into new environments, as the host – symbiote relationship increases adaptability to resources and reduces total risk [Ahmadjian and Paracer, 2000, 225]. The advantage of mutualistic relationships in the Japanese OEM – supplier system is evidenced by the increased willingness of Japanese suppliers to follow their OEM partners. An investment banking analyst that covers the auto parts sector describes these suppliers as going in on "razor thin margins on impossibly low scale runs." They are willing to do so only because of the long-term security that such moves entail, hoping to first supply their transplant partner, and then move on to Big Three customers and finally the U.S. parts aftermarket [Kellogg, July 1988, 16].

Functional conclusion
When faced with the option of initiating a longer-term relationship with a Japanese OEM, the US supplier will see its total risk level fall, not only from diversification, but also through the reduced discounting of future cash flows. In a long-term relationship, these cash flows become less risky, and so capital investments may be employed that would otherwise not be possible with a US based customer. The Japanese OEM meanwhile benefits through innovative and high quality products that it may leverage with the consumer through higher prices and reduced needs for cash incentives. Furthermore, in penetrating new markets, long-term trust present within Japanese-supplier relationships has provided a huge boost in supplier dedication and investment abroad, as Japanese component suppliers follow their OEM customers into emerging markets such as China [Peart, August 5, 2003].

Attempts for System Replication: Deterministic Difficulties

In an evolutionary process, as parts of a system evolve, it is not always true that only the strong survive. Rather, so long as spontaneous genetic mutations (the organic equivalent of spontaneous combinations of old ideas allowing the synthesis of new ones) do nothing to significantly weaken the system vis-à-vis competitors, it is very possible for benign mutations to survive and be carried forward. These 'appendages' may add zero value to the system, and may in fact divert a minute amount of resources away from productive processing tasks. In assessing a system as it stands then, it becomes very difficult to determine what parts of the system represent true evolutionary progress, and which parts merely came along for the ride. As one example, replicating the basic functionality of the Japanese keiretsu system may not work if emphasis is placed on appendage parts rather than where true efficiencies lie.

Further, in assessing the use of evolutionary traits, determining internalized and externalized interactions and resource-processing tasks is a daunting task when it is done without the benefit of the context of its development. It is very likely then, that even as studies on the Japanese system improve in their ability to describe the current system in its totality, understanding the components in the context of the working system will still be lost to those on the outside. Attempting to duplicate such a system, particularly when both the externalized nature of the relationships as well as the internalized support systems are largely derived from foreign environmental constraints, can be very risky indeed.

Any attempt at replication is likely to be costly if done in piecemeal fashion where it is possible that severe losses of resource efficiency may be incurred when significant parts are lacking, or if done to the fullest extent, a misunderstanding on how to direct resource flows could result in failure of even an outwardly identical system. Even modern physicians for the longest time were under the impression that the tonsils were appendages with relatively little use. Now the protection offered by those components of the lymphatic system are better appreciated.

Our understanding of the evolution of the Japanese automotive system is still wrought with guesses, and so determining essential organs from mere appendages is a likewise difficult task.

Progress has been made in the case of the Big Three. GM's Oshawa truck plant is one example that displays the effective duplication of substantial parts of this very complex process. One of the results of increased efficiency and quality, as previously mentioned, is a more streamlined cost structure. GM has benefited from this in the short-run through its ability to profitably execute steep incentive programs that are putting pressure on the higher cost Ford and Chrysler, pressure that is being translated directly to lower competitor profit margins. The progress has not been holistic in nature just yet, perhaps due to the aforementioned difficulties of replicating an evolutionary process through strategic implementations.

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Contact the author for a list of references.

Section 11
Socio-cultural Environment and Sustainable Development

Managing Business in A Volatile Environment: A Tight Rope Walk on Business Ethics, Values and Trust

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Abstract

With increasing thrust upon globalization and liberalization, the market has shrunk to be a global village. The tremendous pressure for prime efficiency, supreme profitability and ever best quality with the lowest of price and ultimate customer delight is paving way to a very big corporate dilemma of maintaining and harnessing these pressures with equal stress upon business ethics and values. For staying ahead in the competitive edge with quest for excellence, many organizations are compromising on the very basic issues of practicing ethics and values. The focus of the paper is on illuminating the mind-set through integration of different perspectives of businessmen, managers, customers and government about business ethics. The paper deals with ethical dilemma and different perceptions of various interest groups on values, ethics and trust in business, throwing light on harmonizing the core issues and integrated trust building amongst various interest groups and provides hallmarks of good strategy.

Introduction:

India is fast emerging as Asian super power in the world market today. At the threshold of changing world, all the industries, trade and services have to reassess their roles and embrace any innovation that would make it more effective and efficient and should grab the vast opportunities offered by the global business scenario. For forging ahead in the global mission, all the business practices have to bear the brunt of the volatility, uncertainty and tremendous competition. The pressure on the organization is rising further due to desirable standards, quality consciousness, commitment towards various segments of society and supreme, of course, the cost-volume-benefit ratio. Many organizations succumb to these pressures and sacrifice on trust in business. The basis of trust in business is frequently sought in the branch of philosophy called ethics and the topic is frequently discussed in the context of social, moral, and democratic processes. But, it is also the source of energy for any economic activity.

Ethics:

Ethics are the code of conduct and some commonly accepted standards and quality, which are bound to tell the difference between the right and wrong. To discriminate between right and wrong comes only from a deeper level. Mere intellectual development is not enough. The capacity to feel must come.

Values:

Values are a frame, which holds us together and gives shape to what we are. They come from the depth of human spirit, which has clear bearing on thinking, doing, and the direction of growth. Values brighten up human life both individually and collectively.

Trust:

The generation of trust means the level of confidence, the sense of feeling responsible, and the belief of being truthful and honest. The Webster's Dictionary defines "trust" as "assured reliance on the character, ability, strength and truth of someone or something."

Ethical Dilemmas:

For centuries together it has been a very popular saying " EVERYTHING IS FAIR IN LOVE AND WAR" This saying with the time has changed into" EVERYTHING IS FAIR IN BUSINESS, LOVE AND WAR".

This quote may raise many eyebrows as doing business and being ethical sometimes sounds to be so contradictory that it seems to be impossible to be both effective and ethical simultaneously. It leads to lot of confusions, chaos, and dilemmas in the action orientation of the business.

Choices in life are rarely simple. Situations do not always develop to one's liking. We are often under the control of others whose values may not be consistent with ours. We then have a dilemma as to what to do, no option being free from a value conflict.

A dilemma exists only when there is a choice or option. If it is not possible to resolve the dilemma fully, one must at least be aware that a compromise is being made. In making that decision to choose or to compromise, it is important to recognize the ethical issues and think through the consequences of alternative resolutions. This requires confidence to seek out different points of view and also tough mindedness.

Most of the dilemmas arise because each option favors one and harms another. The concern for the other has to take precedence over concern for self. The interests involved in any issue, may be of more than one "other", like community, family, society, country and so on. The simple rule recommended is that the bigger unit must get precedence over the smaller unit. Further, long term interests should get precedence over short term interests.

Self, other individuals, family, community, society, nation, world, and the universe are in that order, considered to be bigger and bigger functional units. The concern for every bigger unit takes precedence over all the smaller ones.

Can we Speak of Business Ethics?

Yes. Ethics or Values are what makes it possible to choose between alternatives, and the values held by an individual or an organization are revealed in those choices. Business values are those, which a business needs to pursue in order to survive and prosper as a business. The issue of business ethics covers the entire gamut of business operations which includes ethics in advertising, promotion, compensation, purchases and outsourcing, hiring and firing, accounting and reporting, consumer satisfaction…… and so on. The basic standards, norms, quality, credibility, utility, reliability, etc. all are the important dimensions and a primary concern for business ethics. Money can't buy reputation or integrity, both have to be earned. Organizations based on strongly held shared values amongst its customers, employees, and social segments have been able to professionalize and develop their market potential through strong brand loyalty and relationship building with their constituent. Ultimately, it leads to long-term successes and building and converting corporations into institutions of inspiration for many.

Different Perceptions…?

Trust, Ethics, and Values are perceived differently by different people. There is a famous story about 4-5 blind men who met an elephant and then started describing it as per their own perception one said that it is a big pillar another said that it is a big pot and so on….as they could feel only one part of the big animal. The same is the fate of these Inter-related, interdependent yet separate corporate jargons. The dilemma on the subject is so much that all the important segments of society and business have a different meaning, different perception, different understanding, and different perspective. We all know that in the juggling of these words one can be easily lost in the pool of these words.

Findings:

To examine, assess, and understand the relevance and perception of Trust, Ethics, and Values, as they are interpreted by different interest groups, we have conducted informal telephonic and electronic interviews with some of the businessmen, managers, Govt. officials and of course most importantly some consumers as representatives of the society. The quest included certain basic questions such as:

- o What do you understand by "Ethics"?
- o Is it possible to make reasonable profit by being ethical?
- o How do you balance both the factors?
- o How trust amongst the various interest groups can be created?
- o How much do you feel responsible for establishing ethics, trust, and values in your profession?

Businessmen's Views:

"Trust means faith and loyalty to customer and following some standard ethics including fulfilling some social responsibilities." To quote Shri. Subir Raha, Chairman-Managing Director, Oil & Natural Gas Corporation, India. "….The answer to corruption really lies in the ethics and value system of an organization. If somebody is intent on manipulation and is reasonably smart he will always find ways to get around any procedure." *("Cost of Competition", The Times of India, New Delhi, 2003 August, 6th*)

Certain points emerged from cross section of views during the interview are-

- ?? Being more practical is more important today.
- ?? Whatever is logically right is legally right…. Or you can make it happen
- ?? For success corruption is inevitable- *Sab chalta hai* (anything OK)
- ?? Quality and standards differ from customer to customer and place to place.
  This point is validated by the evidence that the quality and standard of Cokes such as Pepsi and Coca-Cola available in India contains residues of four extremely toxic pesticides and insecticides many folds high more than desired level whereas the test samples for US were found not to contain any such harmful content at all (*Centre for Science & Environment, New Delhi, The Times of India, New Delhi 2003 August 6th*). Still the multi-national corporations claim the charges as baseless.

Managers' Views:

On parameters of trust and ethics, the followings are some of the views expressed by the managers based on their expectations from their employers

- ?? Openness and transparency in the system
- ?? Importance to quality and merit
- ?? Fair policies and practices
- ?? Equality of opportunity

But…Boss is always right.

Government Officials' Views:

If business is following all the norms and prescribed standards, it is always a trustworthy and ethical business. Responsible government officials feel that legal aspect of the business is the most important. The general notions about the fair and ethical business are:

- ?? Fair and transparent accounting
- ?? Proper taxation
- ?? Legal compliance
- ?? Fulfillment of social responsibility.

But… it is difficult to check the corrupt and malpractice

Customers' Views:

In today's consumer oriented market, no one wants to compromise on anything less than the best. Some of the views captured from the consumers during the interview regarding their perception on business ethics, values, and trust are:

- ?? Best quality, lowest price, fair and favorable trade practices
- ?? Correctness of information and reliability of claims in advertisements and promotional efforts

- ?? Best benefits and schemes for customers
- ?? Social contribution
- ?? Long established name and fame matters.

But…Big brands means better trust

Harmonizing Different Perceptions:

All the issues raised above as a result of interviews conducted on the perception of various interest groups on ethics, values, and trust open up a messy world of mixed up meanings and motives. Everyone wants to have ones' own meaning and wants to be happy by closing eye towards the harsh reality of feeling RESPONSIBLE TO SELF, TO OTHERS, AND TO THE MANKIND**,** by manipulating and interpreting the meaning of Ethics, Values, and Trust totally differently.

Thus, the churning of the above points puts a lot of emphasis on harmonizing the different perceptions of various interest groups in a practical and dynamic way so as to stress and establish credibility and perfection both. The important criteria for business so emerged as regard to successful business and balancing progress and prosperity with ethics are:

- ? ? Accountability and transparency in all actions, objectives, and achievements
- ? ? Outstanding customer services by establis hing relationship of utmost good faith and ultimate consumer satisfaction.
- ? ? No compromise on legal, ethical, moral, and social values
- ? ? Vitality of role as an active corporate citizen rather than just a business for profit.
- ? ? Compliance of fairness, equity, law and justice not only for self but also to stakeholders, employees, customers, government, society, suppliers, competitors, environment as a whole
- ? ? Building of corporate image through good will and contributions
- ? ? Belief in harnessing the human values
- ? ? Quality consciousness and global benchmarking
- ? ? Best bargains for best productivity
- ? ? Professional commitment, credibility, pro-action, integrity and honesty, as top virtues

The points mentioned above can be easily dealt with the help of establishing trust between:

- ? ? Promoter and top management
- ? ? Corporate vision and top management's philosophy
- ? ? Business and society
- ? ? Business and environment
- ? ? Management and employees
- ? ? Business and customer
- ? ? Business and network of suppliers
- ? ? Business and government, and so on

All these are to be reinforced by an open and transparent communication system trust building exercises, agreement on norms, standards and ethics and adhering to various values as multi way integration (Fig.1). The dimensions exhibited in the fig.1 are not exhaustive but illustrative and self explanatory.

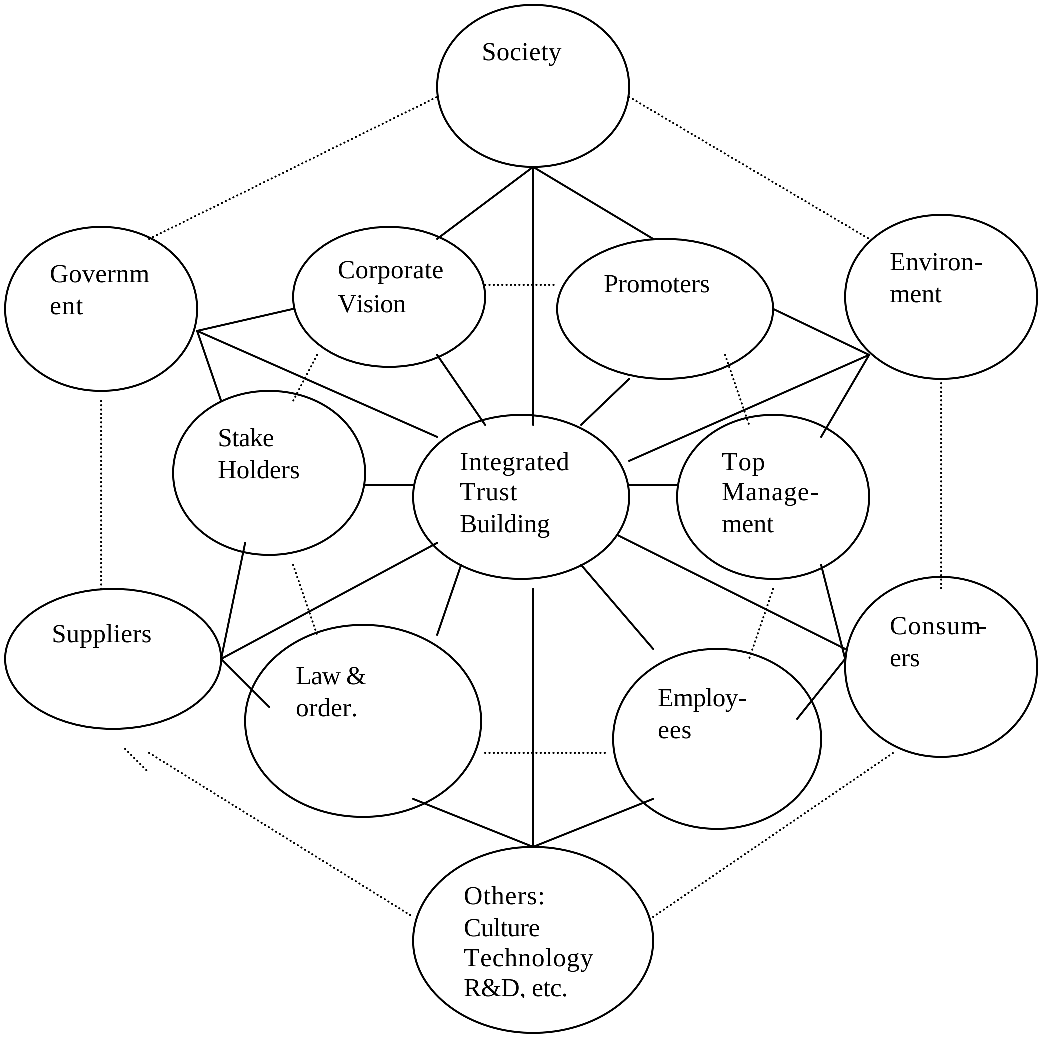

Fig. 1 INTEGRATED TRUST BUILDING AMONGST VARIOUS INTEREST GROUPS

The Emerging Corporate Social Responsibility (CSR)

The concept of CSR is now gaining a very important momentum in the business philosophy for generating and reflecting the impact on society in the context of sustainable development globally. It focuses on a white paper on issues related with contribution to sustainable development including environmental and social issues, human rights, local impacts, care for stakeholders, transparency, corporate governance and issues taken up for strengthening the trust. It also includes social reporting on human resources, community at large, labor standards and environmental issues. For many old business tycoons in India like the Tatas and Birlas, the corporate giving has been a tradition. Whereas the relatively new info-tech companies like Infosys and Wipro are headed by ethical professionals and have a corporate conscience. When global companies came to India, they made CSR as important a stamp as ISO-9000. The CSR strategy is now more like a fashion or brand statement. Rajat Gupta, MD, McKinsey and Co has this to say: “Enlightened corporate see it in their best interest, and that is what is driving it. We give back not merely by writing cheques, but by offering time, space, and skills". Pradip Kashyap, who runs American Indian Foundation from office space in New York's Madison Avenue, given by McKinsey, says:" The corporate culture in the US makes it impossible to do business unless corporations reach out to their stakeholders through philanthropy".

Hallmarks of Good Strategy for Ethics, Values, and Trust Building:

- Guiding ethics and values should be reflected in the commitment of each and every step taken by the Corporate, which should make sense, and clearly be communicated.
- The Corporate leaders, manager, and workers should be personally committed, credible and willing to take action on the values and ethics they espouse.
- The trust building exercise between various interest groups should be based on OCTAPACE values.
- The interpretation of ethics, values, and trust should flow and reflect in the decision making, empowerment and all the critical activities of the organization.
- The systems, procedures, structures, and policies should support and reinforce the ethics, values, and trust.
- The human power within the organization must generate the competence and inner strength to work on the aforesaid ethics and values and for this, competency building and empowerment must be initiated.
- To permeate these virtues in the manpower frequent and regular motivational exercises, workshops, Seminars, meditation, etc. for everyone from top to bottom must be conducted.
- The source of fresh water in the nature flows from top to bottom in its natural course. The same is equally true in the business that honesty, integrity, hard work, punctuality, loyalty, commitment, and practice of moral and ethical values should flow from top to bottom.

Here it is apt to quote Mahatma Gandhi, according to whom, the seven sins are:

- Politics without principle
- Wealth without work
- Pleasure without conscience
- Knowledge without character
- Commerce without morality
- Science without humanity
- Worship without sacrifice

Let us keep away from these sins and enlighten the world to forge ahead on the path of ethics, values, and trust. Though, it is very difficult but not impossible. Let us make the world a better place to live.

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Searching for the Way Ahead for Cypriot Companies in a Changing Environment: An Exploratory Analysis from the Local Business Leaders Perspective

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Abstract

Cyprus is one of ten countries that have been granted entry into the European Union. Despite the fact that Cyprus is attracting renewed attention because of this fact, little has been done to understand how Cypriot business leaders, the architects of the country's economic success, view the volatile, rapidly changing internal and external environment. The orientation of this study was originally an exploratory one, covering a holistic perspective in search of key emerging concerns. From early on the issue of change pervaded discussions most subjects raised. Cypriot leaders realize that dealing successfully with current challenges, such as global competition, is instrumental to their companies' survival. They are responding, if hesitantly. They are reluctant catalysts of change. Being part of an old culture that is seeped in tradition, they are tempted to resist. But they are well aware that they will be left behind if they do not keep up, so they are instigating change.

Introduction

The Republic of Cyprus is one of ten countries that have been granted entry into the European Union (EU) as a full member. On the 14th of July 2003, the country's parliament voted 'yes' to accession, thus opening the way for formal membership in May 2004. In a practical sense, the impact of this development will not be overly dramatic. In fact, this has been intentionally so. Cyprus has been harmonizing its regulations, policies and legislation to fit the corresponding ways of the European Union for more than a decade. For example, the Value Added Tax (VAT) has gradually risen from non-existence to the mid teens, thus now essentially matching the European standard[1].

Even if this change toward EU harmonization has been relatively smooth, the fact remains that the local business environment waters are being stirred. Globalization is now directly affecting every corner of the world. Competition has intensified at company and labor level. The pace of life has quickened. The average life expectancy of businesses in Europe and Japan is just 12.5 years, according to a recent Dutch survey. Even the average life expectancy of a Multinational ranges between just 40 to 50 years. So why do some firms continue to survive? One explanation is that they learn - and change - effectively (Pollitt, 2003). Can Cypriot firms effectively survive transition?

Cyprus, a small independent island state in the Eastern corner of the Mediterranean Sea, is now attracting renewed international attention because of its new status as EU member. Thus far, focus has mainly centered on macroeconomic factors and the country's ability to stay within the indicators set by the Maastricht Treaty. However, little has been done in the investigation of business at a more personal, detailed and culture-oriented level. The voice of the architects of what used to be referred to as the 'Cyprus Economic Miracle', the local business leaders, has rarely been heard, at least from an academic, analytical and explanatory perspective. The purpose of this study was to examine the way these people view the volatile work and cultural environment they themselves are part of.

The importance of Studying Business Leaders

The importance of studying business leaders and what they have to say is continually being emphasized (Caudron, 2002). Leadership has been heralded as an important ingredient for the revitalization of organizations (Peters, 1987). It is known as one of the essential components of a successful operation (Dare and Boissezon, 2000). The field is also important from a sociological-psychological perspective, because it directly contributes to the improvement of people's lives (Kilduff and Day, 1994).

It is important that business leaders understand themselves. But it is probably even more important that others understand them. Dunn (1979) points to the necessity that western businessmen understand both the emotive and cognitive aspects of its (*the Middle East's*) managers, if they are going to be able to deal with their counterparts in that region.

Also, studying this particular group within a society is significant because leaders help shape society as much as they are shaped by it. Leaders have a significant role in creating a state of mind that is 'society' (Gardiner, 1985).

Moreover, there is profit to be gained by seeking information from experienced people in this area of study, tapping into their collective memories and experiences (Cooper and Shindler, 1998), because it is 'inside' information.

Learning about Cypriot business leaders is also of value for the purpose of completing a global management 'puzzle', for academic purposes. But there is a significant practical benefit as well. The individuals themselves can stand back and see how the system (*context-specific*) works and thus be better able to modify it (Lawrence, 1992).

Given these facts and the obvious gap created by the relative unavailability and triviality of local information[2], coupled with a continuing frustration over the abundance of mainly American management-leadership studies (Adler, 1997), led this researcher to look into the perspectives of Cypriot business leaders further. This information can be a key for understanding local management practices, both for observers from within and outside.

Challenging Times

There can be little doubt that difficulties lie ahead for Cypriot businesses. Staying on the easy, slow lane is no longer a viable option. Apart from the EU entry, organizations, and the people who run them, are being forced to move faster than ever before (Stalk and Hout, 1990). How do Cypriot business leaders see these changes? Are they feeling threatened? By and large, small cultures in general (*like Cyprus*) are susceptible to changes due to acculturation, thus rendering studies such as this one relevant for other similar environments.

For various reasons (e.g. the follower now demands more influence, he is better educated), the leader-subordinate relationship is also in a state of change (Block, 1993, Hollander, 1990). For example, there is a noted decline in member commitment and loyalty (Hirschhorn, 1998). Partly due to the increasing importance of the employee, there is currently also an increased concentration in leaders' people skills. In fact, research interest in leaders' social skills has been put on centre stage. Gone are the traditional key words like 'control' and 'command'. The new words are 'communicate', 'collaborate' and so on (Abramson, 1999).

The issue of change has been exacerbated by external forces as well as internal. In the past, people stayed closer to home, rendering behavior more predictable. Now, we interact across cultures, widening our range of human contact and 'shrinking' the world in the process (Hall, 1976). As a result, business today is increasingly being impacted by international considerations (Darling and Fogliasco, 1999). First, it was through bilateral and multilateral agreements, then by means of regional pacts such as those of the EU and NAFTA and, increasingly, by way of globalization in a sense few could have envisioned a few years back.

It must be reemphasized that small cultures, as is that of Cyprus, are often subjected to acculturation, that is, that they are heavily influenced by dominant cultures (Segal, 1981). Thus, it can be assumed that Cypriot managers are also affected in this way. Then, it could be argued, Cyprus is also moving out of its 3rd World setting, from a 'traditional' to a 'modernistic' mentality. Modernism has been associated with achievement (McClelland, 1961) and it includes such elements as are (a) independence from traditional authority figures (Inkeles and Smith, 1974), (b) abandonment of passivity and fatalism (Kiray, 1968), (c) ambition for one's self and children (Kiray, 1968), (d) individualism (Kahl, 1968) and (e) trust in one's fellow humans (Kahl, 1968). This modernism, if it is occurring, involves change.

Challenges, such as these cited above, are rising in importance. It can be safely asserted that the issue of change has now increased in significance, on a local as well as an international level. As La Barre (2000) concludes, change is the biggest challenge businesses face today. Hence, it is an increasingly important focus of attention in today's organizations (McLagan, 2002) and in management research. In fact, change is a key concern in the impact of management performance (Harris, 1985). In truth, this is no revelation.

The Impact of Culture

Also, it has long been recognized that diverse cultures are receptive to change in varying degrees, sometimes dramatically so. This relationship between culture and acceptance (or initiation) of change was identified as far back as half a century ago (Barnett, 1953).

It must be stressed: Change has always been with us, in management practice and otherwise. The difference today is that change takes place in a generally much more rapid manner than in the past. The pace is such that, literally, were one to blink he may find himself lagging behind. Of course, this pace has varied in different developing and emerging economies, some necessarily adopting emergency 'shock therapies' (e.g. Russia, Poland) and others attempting a more gradual shift (e.g. China, Vietnam) (Peng, 2003).

Still, generally, productive cultures have some common traits, as are those of rationality in decisions on actions, *handling of change*, alertness to new opportunities and energetic enterprise (Herbig and Dunphy, 1998). Hence, it has been concluded that 95% of business approaches are the same (Freeman, 1989). In fact, Farkas and Wetflauer (1996) interviewed 160 CEO's from around the world and found surprising consistency in their leadership approaches. These individuals are essentially motivated by achievement, power, status, income and advancement (Campbell, 1970) and these specific motivational needs are similar across many countries (Haire, Ghiselli, Porter, 1966)[3]. Moreover, Massie and Luytjes (1972) reviewed management practices literature in all continents and concluded that there is a trend toward similarity in management practices despite differences in managerial emphasis. And, according to John Adair (Powell, 2000), a leadership guru, the three main leadership 'circles' (the task, the team and the individual) are universal in all cultures.

Nonetheless, Hofstede (1983) states that the assumption that 'management is the same or becoming the same around the world' is a 'naïve' one. To Hofstede the influence of culture on management behavior is so important that he refers to it as software of the mind (1994). In addition, many researchers contend that management styles are culturally determined (e.g. Wright, 1981, Aram and Piriano, 1978). Also importantly, Trompenaars (1996), who investigated 15,000 employees in 50 countries, found that there is a unique management solution in each culture.

Kets de Vries (1999) used the case study format to look into the lives of global leaders, such as that of Richard Branson. He found that the new leader must behave differently because the environment is changing. For instance, due to rapid change, knowledge is now even more a critical factor. Do the Cypriot leaders understand its importance?

Thus, the cultural context is significant. Top management strategies are above all cultural (Drucker, 1985).

Negandhi (1983) investigated the future directions of management research. He concluded that such studies are shifting from management practices analysis to the psychological terrain, probing the motivations and personalities of top managers, and especially those from Third and Fourth World countries. The focus of this study was in line with this continuing trend.

Methodology

Leadership shares some characteristics with the Complexity (Chaos) Theory (Thitart and Forgues, 1995). That is, causal analysis is 'virtually impossible', because the number of variables jeopardise one's ability to understand causal roots. This is one of the reasons why leadership studies produce such mixed results. Out of literally thousands of studies, there are few, if any, authoritative studies that are universally accepted (Yukl, 1989), probably because of the diversity of the subject matter, rather than due to flaws in the studies themselves.

Leadership, culture and environment stubbornly defy measurement, and it is within this context that Cypriot business leaders needed to be examined. A quantitative data analysis approach would necessarily have had to omit factors that may have been important in the lives of individual leaders. Even multivariate analysis would have had its limitations, in terms of data amount, in producing a manageable and comprehensive document of the findings. Qualitative research, on the other hand, would recognize the complexity and diversity apparent in the leadership field.

Such issues are best understood when viewed from a *holistic perspective* (Hollander, 1978). This sort of an outlook effectively does not dismiss any of the previous diverse work (or schools) of leadership research. Kelly (1998)[4] addresses a 'whole person' approach to leadership that far too many other theorists ignore. It includes research on personality, leader-follower relations, and the work and cultural environment. This broad-based perspective is especially useful in exploratory research, when little is known about the phenomenon. Due to the fact that leaders in Cyprus had not been adequately studied, such a point of view seemed particularly appealing.

This study was initiated using the above outlook. That is, leaders were free to talk, to express themselves, thus 'allowing' the important issues to emerge by themselves, rather than being forced out. This is not to say that the research study began with a blank sheet. It would be 'foolish' to imply this (Wolcott (1982:157). The main instrumentation tool, the interview[5], was a semi-structured one, providing both direction and flexibility (Miles and Huberman, 1994). Perhaps surprisingly, it has been shown that non-directive interviews where both sides talk freely only serve to confine both parties (Easterby-Smith, Thorpe and Lowe, 1995). Researchers can be more successful if they are clear at the outset about the general areas of interest. In effect, this study was conducted in a philosophical sphere which lies between phenomenology and post-positivism. Particularly, the study began at an exploratory and descriptive level, yet later, as patterns emerged, explanation was attempted.

Using such an approach limits the number of interviewees. This does allow enough space for generalizations which, however, cannot show how often (probabilistic generalization) any patterns may occur. Rather, this approach contributes toward analytic generalisation, checking the findings for fit with previous research and theory, or with similar cases. If linkages and patterns can be found within these parameters, then analytic generalisation can be assumed (Gilgun, 1994).

Another common concern in qualitative research is that of reliability. A useful way to claim reliability is for the investigator to document his procedure well (Kirk and Miller, 1986:52-72). Hence, the entire contents of the interviews, which typically lasted about 2 hours, were transcribed word for word, including syntax and other errors on the part of the interviewee and interviewer.

Triangulation was achieved by cross-referencing issues with leaders' acquaintances and by observation. Also, by asking about the same phenomena across cases (Gilgun, 7:1994).

Selection was largely purpose driven. The number of leaders to be interviewed was not absolutely predetermined. Rather, the followed process was opportunistic and structured. Following the pilot study, thirty-six local business leaders were ultimately included in the data analysis. Anonymity was guaranteed to ensure that the leaders would openly express their feelings.

Despite the fact that probabilistic generalisation was not a direct goal, it is worth nothing that some characteristics of the studied Cypriot business leaders did emulate certain attributes of the broader population. For example, in the overall population 76% of firms are owned by the General Manager and/or his family. This proportion was also attained in the selected sample (77%). Also, 93.6% of the population are men, thus, overwhelmingly (bar one person), the interviewed leaders were men. Most Cypriot business managers are relatively young [70% of Cypriot General Managers are below 50 years old (Keravnos, 1998)], so a changing of the guard is happening right now. This proportion was adhered to. People over 45 years old was also represented, constituting 31%, in a manner befitting today's local business reality.

Some diversions from the population suited the purposes of this study better, and reflect an intentionally selective focus. For example, the selected companies tended to be larger, in terms of personnel, than the average Cypriot firm. Most Cypriot companies (94.8%) are 'microenterprises', employing fewer than 10 employees. In this study's sample, the aim was to select more successful firms. A higher number of employees were utilised as a success criterion, as financial figures were scarcely available. Thus, the average number of employees in the selected sample is 28.6. When one considers that only about 5% of Cypriot companies employ 10 or more employees, it is easy to see that the selected companies are 'loaded' in this area. There are but a few hundred companies belonging in this 'elite' category. As a result, reliable assertions can be made about leaders within this area.

In terms of the nature of business the selected firms were engaged in, an effort was made to choose companies from a diverse spectrum, to increase the chances of covering varying factors and issues which may have emerged in different areas. So, despite the fact that most economic activity is derived from services, a better 'balance' was sought here. There were 22 companies involved in services and 17 engaged in manufacturing and production[6].

Several techniques were utilised for data analysis. The interviews and observations were transcribed verbatim and then transferred to a specialist qualitative research software package (Nud*ist). Then, the data was manipulated by coding (pre- and post-), inserting marginal remarks, creating 'contact summaries', memoing, and by constructing checklist matrices and coping charts.

Findings

It is important to note that many leaders were found to share the 'experience' of the Turkish military invasion of 1974. For some, this directly affected business. A few had to start all over again, or open a new business (e.g. leaders 2, 6, 10, 12, 13, 19, 31). Many mention the traumatic effects of the war, either on a personal or a business level (Leaders 1, 3, 4, 6, 7, 9, 11, 12, 13, 15, 17, 19, 21, 22, 24, 28, 30, 31, and 32). It is also probable that the war had 'positive' side effects on business, in terms of improved personal resilience, emphasis on education and a focus on building the future rather than concentrating on the past. In other words, it may have provided an impetus, a feeling of forcefully starting afresh. Also, it is possible that some fear of risk and reluctance to change may be tied to the above distressing event. Future research would do well to directly research the impact of the invasion on the local leaders. Below is an excellent summary of the Cypriot spirit:

"… the Cypriot does not stop somewhere … of course a lot depends on the factors you are 'given' … because you can see difficulties in Europe (*our entry*?) but the Cypriot I believe is the person who pushes forward. After the invasion we became stronger. There were people who were 'high up' and ended up with zero. And they re-created themselves. And this is one of those factors that make Cypriots not stop, rest on their laurels… after the Turkish invasion there was a rapid growth in Cyprus. The invasion stagnated everything, yet the Cypriot still survived. He went abroad, to the Arabic countries, brought money back in. I believe the Cypriot marches on." (Leader 30)

The issue of 'change' sparked a lot of lively conversation and responses from several business leaders. No matter what was being discussed, (e.g. the country's development, employees, and current practices) change emerged as a key topic. Table 1 is part of a Checklist Matrix depicting relevant remarks made by some of the leaders. It provided a useful summarized presentation because of its immediate proximity to actual leader comments. Also it constituted a useful springboard upon which issues could be correlated, further investigated, and explanations attempted.

TABLE 1: CHECKLIST MATRIX ON 'CHANGE'

Leader	***Adequacy Judgment****	***Remarks*****
1	4	Pessimistic when asked about change: "You have to be naïve to think the human race will change overnight, people (employees) will always want power". "At work, you can see the struggle for power everywhere".
2	2	Associates change with employees negatively: "Trend is for staff to work less hours, not be so productive, to get more money". (employees) "We have rapid change but we are saying that our staff can't follow, and we expect them to catch up with us." (employees) Associates change with travel: "We go abroad and we see these changes… we have a problem investing in new technology… because we don't have any help from the government. They're useless they don't care about our work. Why risk 1 million pounds in new technology when the minister says that this business is dead. They are trying to kill you. It's dangerous.
3	2	"If there is a need to change something you have a contingency plan, you can adjust. Professionalism is VERY important." On rapid change in Cyprus: "Tourism ... happened very suddenly… a sudden change and they didn't have the correct structure. Regarding himself: "I am trendy. Changes happen every day, I adjust all the time."
4	2	Says Cyprus is changing from 'Middle Eastern culture' to 'European. "Family orientation, more conservative regarding changes (and) technological advancements". (family) (modernism) Is he a trendsetter? "No… changes should be done in a linear kind of way, not very dramatically (i.e. Slow change). Because there are a lot of risks. I don't like to do something without knowing the risk I am taking."(Security)
33	1	Some cultures, like Greece, live in the past. Others, like UK and France, live in the future. Cyprus lives in the present. Cypriots don't adapt, change easily. (culture) Says his adaptability is his strength.
34	2	Must Cypriots change? "The Cypriot manager wants everything to pass through his own hands. (management) I think very few Cypriots have managed to get away from this tendency." "I have changed my mind compared to my father. He had it for certain that I was to follow his footsteps. I was the continuation. If I had not followed through he could've died. I say, if there's somebody better than my son who will continue the business let him continue. I can sell. To someone who likes it, who loves the job. Why should I force my kids to come here..." (family) "The mistake is that they don't continue to educate themselves (the older managers) (Old and new) Now, the new ones after us will contribute to change. Because more decentralization will happen in companies (management). Prefers "change. New technology, new ideas, man cannot be static. When waters are stagnant, things go bad"
35	3	Cypriots have no desire to change things. (culture) "The way of thinking (should change)….let people be... then we would achieve more."
36	2	"But times have changed, it's not easy to be a manufacturer in Cyprus, because of a lack of labor… we are a small country." (small)

**Adequacy judgment key: Strong = 1, Adequate = 2, Weak = 3, Don't know/can't tell = 4. This grading is based on a number of criteria, including leader remarks, observation and personal judgment.*

*** The identified recurring key concepts were placed in parentheses.*

The following patterns emerged from the analysis of 'change' for the studied Cypriot leaders.

a) The issue of change is crucial to them.

b) Change and culture are inevitably linked. The 'culture factor' repeatedly featured in leader responses. At least 22 out of the 36 leaders associated or related Cypriot culture with change.

c) The Cypriot leaders, being immersed in Cypriot culture, are certainly affected by the norms. Because Cyprus is generally a conservative society, many leaders are careful with change. Still, most profess an inclination toward change. Eighteen of them clearly state this, and only five leaders openly do not support much change (Leaders 7, 13, 14, 28, 29). In this latter group, Leaders 7, 13, 14 and 28 have taken over successful family businesses. Although none of these leaders have had 'very good' development, three of them have had 'good' development, an indication that their reluctance for change may have worked for them, to a degree. This is possibly because of the comparative uniqueness of their industries and relative lack of competitive pressure (a tannery, marble producer and bedding manufacturer). Still, it is useful to see an assessment of a typical Cyprus business by one of the latter leaders:

"In Cyprus, most are small businesses, like families right? And the son comes up in the business, but nothing much changes, because he has been trained by the old man to do things a certain way (family tradition prevails). The children finish their education, become directors, have a nice car, get married, have children and their life is settled for the next 40 years…" (Leader 29)

This same individual stated that he prefers stability because "it calms things down". In fact, many leaders prefer slow, steady changes. Leaders 4, 6, 8, 17, 20 and 26 expressly stated their desire for such step-by-step change.

Another leader (4) offered a good typical explanation, which he associated with culture. He said that Cyprus is changing from a 'Middle Eastern culture' to a 'European'. He explained Middle Eastern culture as representing family orientation, and more conservativeness regarding changes and technological advancements.

Another explanation to a seeming reluctance to change was attributed to the small size of the Cyprus market:

"I don't like very rapid change. I want us to grow fast but I realize the limitations of this market". (Leader 8)

This smallness is an oft-mentioned concern (Leaders 7, 8, 24, and 36 expressly mention this in association with 'change barriers'), as a reason why growth is stifled. According to several leaders (seven of them directly mention this), the fact that Cyprus is dominated by small businesses will negatively affect future prospects, unless something is done to change this trend. Some believe (e.g. leaders 3, 8, and 19) that many small businesses will close down; they won't be able to live up to competition, especially imported competition. This is an even bigger concern when the studied leaders consider our entry into the EU. A relevant search revealed a lot of concern. 83% (30 of 36) of the studied leaders refer to this matter in one way or another. Certainly there is more concern, than the opposite. Only three leaders (9, 30 and 33) see the European Union entry positively. Nine others are clearly concerned about this prospect. For example, Leader 12 fears that Europe will reveal our 'business weaknesses'. Below is a typical response:

"There are very few Cypriots who are *professionals* (my emphasis), that's another criticism. Our structure, if we are not very well *organized* (my emphasis), will suffer. Especially when we get into Europe. I am not sure about that, the EU… In Cyprus we don't have the background, or the knowledge or the infrastructure to really grow. The only thing that might work is services. Which foreign companies will come here? The raw materials must be imported, *productivity* (my emphasis) is not here (*i.e. high*), technology is not here (*i.e. high*), electricity is very expensive." (Leader 13)

The above shows that there is concern, that Europe will somehow expose this country's apparent lack of professionalism and productivity problems.

There is a tendency to shift blame for an apparent change for the worse to other external factors as well. *Government* takes much of the blame. Government is mentioned in 26 out of 36 documents (72%). Incredibly, twenty-three of those mentioning government gave negative remarks, some even directly blaming government for business decline.

Despite the aforementioned concerns, the studied Cypriot leaders are confident that they can cope with changes and crises. Perhaps this confidence can be attributed to knowledge. There is an understanding that change requires one to know where he is going. A blind plunge is not the way to go about it. A couple of examples:

"…If I don't know something it's hard for me to try it. I won't risk doing something I don't know just because someone told me to", says Leader 26.

"I wasn't scared, despite the big risk, because I had good knowledge, I was confident in what I was doing." (Leader 7)

Most respondents support the necessity of knowledge about a venture before one initiates it, thus taking a calculated risk (24/36 or 66.6%)[7]. This is in line with the individuals' guarded response to the necessity for change. One manager clearly states the relationship between caution, change and risk:

"… my personal opinion is that changes should be done in a linear kind of way, not very fast, or very dramatically. Because there are a lot of risks there. I don't like to do something without knowing the risk I am taking." (Leader 4)

The need for learning and knowledge is also reflected in the General Managers' behavior, especially regarding their travel habits. Twenty-seven of them clearly state that they travel on business or to exhibitions, and in most cases extensively. They go abroad to see how their international counterparts are progressing. There can be no doubt that there is influence from abroad at a practical and, also, academic level: The selected sample typically included a large number of graduates from overseas (10 from the UK and 10 from the USA).

Many leaders associated 'change' with another Cypriot cultural characteristic (perhaps a tying element or 'key concept'): Family and family orientation. A typical remark:

"…as things are today, it's very difficult to escape the family orientation of businesses. In some industries, the family basis in business will remain in the future as well. It is difficult… because of the amount of business in Cyprus (*not much*)." (Leader 34)

The central role of the family within the local social and business fabric is essentially taken for granted by the participants. They inevitably, somehow, associate family with their business, their values, and the necessity for change, their behavior and even their motivation and goals. Importantly, there is a persistent conviction, when the subject arises, that a consequence of this orientation is stifled growth (e.g. s: Leaders 2, 3, 4, 11, 17, 29) because it promotes a lack of professionalism. This professionalism, or rather its absence, is interpreted in several ways:

[I] A prolongation of family-based mismanagement. A typical quote:

"We are family operations, this must change. I don't see it continuing this way, because this stifles growth." (Leader 11)

[II] The employment and promotion of family members and friends who may not be as capable, thus holding down productivity. Nepotism and cronyism is reportedly rampant. A typical response:

"I think management in Cyprus is not professional. The manufacturing units of any business, footwear, clothing have been based on the 'family business' concept, which is very unproductive, in my opinion. That's one reason. The second reason is that workers aren't very professional themselves, they don't…" (Leader 3)

[III] The use of networking, rather than a good product or sound business practices in order to advance.

"We are also a family oriented society, helping relatives. Whatever you do here depends on contacts." (Leader 24)

Many leaders (for example, leaders 1, 2, 3, 12, 13, 17, 22 and 33) talk of two types of employees. They refer to the new employee who is not as loyal and also to an inner more trustworthy circle and another less trustworthy one. Often, the inner circle consists of family members.

"(The) trend is for staff to work less hours, not be so productive, to get more money". (Leader 2)

It is also seen as a gradual degradation of values, such as the old work ethic. Leader 13 says,

"Then (mid sixties) Cypriots were willing to work from early till late at night. Of course things have changed somewhat now. With the new generation the old Cypriot pride (is gone)".

Leader 32 reinforces this:

"I see changes in the youth, some principles have been sacrificed… respect…"

The aforementioned family orientation may extend to a paternalistic management style (e.g. leaders 8, 9, 21, 24, 26, 29, 31 and 32), where there are mutual expectations of long term employment and interpersonal involvement. However, a more rational management style is increasingly being favored. All are experienced decision-makers, there can be no doubt. But, only a very few exceptions (e.g. Leaders 28 and 30) may still be steadfastly adhering to old-fashioned arm-twisting methods. Again, there is a sense of change here:

"They *(managers)* are getting better because more of them are getting educated. The past ones were too tough on employees, they did not know much about psychology." (Leader 10)

Conclusions

Change and adaptability are key ingredients in the 'transformational' model of leadership, which is widely considered a more effective leadership style in most contexts (Lowe and Kroeck, 1996). As Kilduff and Day put it, 'chameleons' do get ahead, according to research (1994). Accepting change and dealing with it requires a lot of self-confidence, and leaders are ideally equipped, in terms of personality, to deal with it (Bowman, 1999). Leaders are 'reducers', who can handle complex, novel situations without impaired task performance, or cognitive disorganization, or health problems (Kets de Vries, 1989).

However, it must be said, even leaders within similar cultures can vary. This difference is much more emphatic when one crosses international borders. For example, Jim Durcan (1994) takes a 'cluster' approach to leadership. He describes Mediterranean leaders as 'insulating' employees from market fluctuations. Regarding change, it is the leader's job to make sense of it.

Nonetheless, primarily, one must keep in mind the pragmatic fact that leadership can be different in every situation (Saal and Knight, 1988). Also, that measures of effectiveness are very difficult to identify and isolate (Hogan, Curphy and Hogan, 1994).

Having clarified the above, some common factors did emerge in this study. Cypriot leaders do share some of the concerns and problems that their international counterparts are currently facing. For example, the issue of change, and dealing with it, is of global concern, not only of Cypriots.

The 'people' element has risen in importance in many countries, Cyprus included. The relevance between leadership and social skills has taken a central role (Abramson, 1999). Cypriot managers are coping well with the social-capital challenge. For instance, they can adapt well to varying social situations. Cyprus may be a small country, rendering contacts a crucial aspect of good business, but networking has attracted increasing global attention in recent years (e.g. Low and Macmillan, 1988; Sjarka J., 1990).

The studied leaders are able to deal with uncertainty and change [key leadership attributes] (Smith, 2000), even if they do so reluctantly. They give the impression that they understand that today's leader needs a new approach to that of 15 or 20 years ago (Horner, 1997). Cypriots recognize the necessity for change, and they are not standing still. Although they are careful, they do try to learn about future possibilities (Eisenbach, Watson., Pillai, 1999). They understand that now knowledge is a critical competitive factor (Kets de Vries, 1999), so they keep learning from abroad. They travel extensively; they know how foreign companies are being managed. They seem to want to make the necessary changes, while recognizing their own, and their country's, limitations.

Here, there is a group of individuals who are inevitably affected (and even afflicted in certain circumstances) by what is the Cypriot culture: A less than fully organized society, rather Middle Eastern-style, one could assert, which is intensely family oriented. Being as such implies that family and friends can take precedence before what may be called professional business behavior. As a result, these leaders are not beyond nepotism and cronyism, even if they recognize the need for change. Also, they often display some paternalistic leadership elements, sometimes being tough and sometimes soft, while all the time displaying real emotions about the business and its employees. Being somewhat casually organized, these people are not champion team builders.

But this culture is in a state of change, moving toward a more European model. A large number of individuals are formally learning their trade abroad, mainly in the USA and the UK. Moreover, through extensive travel, these businesspersons can be said to be receiving a continuing education from overseas. These leaders are standing at a vantage position: They can see what needs to be done, they are not ignorant; they know what they must do. Now they are changing, even if they are doing so cautiously. They, along with their culture, are resisting, yet they are changing.

The studied Cypriot business leaders are reluctant change catalysts, because they perceive stifled growth due to several factors: First, the 'new' Cypriot employee is not as productive or loyal as he used to be. Second, environmental factors, such as government and the smallness of the market, are real barriers to growth. And third, the imminent entry into the European Union, with the added competition, may entail negative repercussions, especially in the small business sector, which is the dominant one in Cyprus.

References

Contact the Author for a list of References.

End Notes

[1] For an excellent chronological presentation of the Cyprus EU accession efforts refer to http://www.cyprus-eu.org.cy

[2] A notable exception is the Cyprus Industrial Authority study on local managers, conducted in 1992.

[3] Although, in their groundbreaking study of 3,641 managers in 14 countries, they found that 28% of the variance in managerial attitudes could be attributed to nationality alone.

[4] In her review of K. Cashman's book, "Leadership from the Inside Out", The Academy of Management Executive, ADA, Aug. 1998.

[5] The interview was supported by observation, mainly for triangulation purposes.

[6] Three companies are involved in both manufacturing and services.

[7] The other managers were not against the necessity for risk. They just did not expressly state the opposite. Only one respondent indirectly does so, saying he is conservative.

Constructing Communities: Advantage, Innovation and the Management of Local Economic Growth

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Abstract

This paper discusses, in a preliminary way, the new dialogues that successful knowledge-intensive communities have adopted in order to achieve global business growth. Using empirical data on innovation from cities in Canada and the United States; innovation governance models from small and medium sized countries including Scotland, Denmark, Finland, Sweden; and using differences in technology sectors – particularly telecom and photonics – this paper will present some modest insights into the path dependencies of small firms, small nations and globally competitive innovations.

Introduction

Governance is about handling complexity. It is fundamentally about interdependences, linkages, networks, partnerships, co-evolution and mutual adjustment [1]. In international business studies, this set of facts is well known.

For Robert Putman, governance is about building a strong and active civil society[1] [8]. In his excellent study of the political economy of Italy, Making Democracy Work, [9] he details how bakers or priests can have more political and business decision-making power than mayors. Yet a stable civil society is sustained. He also documents how macro-fiscal and monetary policies can actively hinder the growth of firms, ensuring an economy of small firms – thus, they think, protecting Italy's rich culture - and inadvertently promoting the shifting of Italian multinational industrial investment and activity over the borders, to France and Switzerland and further afield.

For Richard Florida, the importance of place in a knowledge-driven economy is key [4]. Constructing communities involves developing an organizational ethos that now signifies successful firms, cities and regions. Florida refers to this clutch of ideas as 'the rise of the creative class'. On the surface of course, this basic presentation may seem facile and non-operational from an urban planning, mayoral and managerial perspective. However, if one were to look, even at the most elemental of ingredients, involved in creative knowledge-intensive communities, then we could boil it down to the availability of infrastructure (both physical and smart – i.e. connectivity), leadership, capital, and people. Urban planners, in Florida's world, might observe that quality of life, as represented by bike paths, a clean and recreational environment, safety, orchestras and other cultural venues – including blues and jazz clubs, good school, cinemas, a vibrant downtown, and so on all are attractive to highly educated workers.

Florida and Putman both understand that communities are based on adaptive relationships,[2] [2] networks and mutual interests.

In a networked economy, private ownership gives way to social space. Jeremy Rifkin refers to this as "the age of access". [10]. In a broad sense, one could differentiate between differing types of networks.

Rifkin likes to point to supplier networks in which organizations sub-contract for a range of inputs; to producer networks in which organizations pool their production facilities, financial resources, and human resources; to customer networks in which manufacturers, distributors, marketing channels, value-added re-sellers and end users work together; standard coalitions in which as many organizations as possible establish standards of practice around the industry leaders; and technology cooperation networks in which valuable knowledge and technical expertise is shared [11].

Using these ideas, this paper will sketch out some recent work on cities, the interactions between cities, and the governance of innovation in some smaller nations as they try to create communities in their quest to construct advantage around science, technology and knowledge.

The Case of Some Canadian Cities

Cities of course are at the heart of economic growth in any country. In 2001, the Canadian Advanced Technology Alliance (CATA) launched a series of TechAction Town Hall meetings. This was in partnership with KPMG and other industry sponsors and under the research design of John de la Mothe.

The TechAction Town Hall meetings, held across Canada, involved executive community stakeholders who gathered to voice their concerns and pool their ideas about how to stimulate innovation and knowledge-based industrial growth. The goal of this series was to create a community based consensual for specific actions to grow the community's use of high technology in the near future. The TechAction Town Hall meetings had two components:

1. An extensive survey of city executives and leaders, and
2. The business and community leadership surveys which were used to create an 'Action Blueprint' to advance community growth:

Here is a summary of some outcomes at the local level.

Calgary, Alberta

Having established an advanced technology centre, Calgary is confident in its capacity to innovate and that it will play a vital role in a national effort to improve innovation. Access to capital remains an issue. Calgary, however, possesses well-educated human resources, an adequate technical infrastructure and highly skilled leadership. Calgary's challenge is to put in place the financial measures to sustain its momentum in the coming decade.

Action Blueprint: Calgary's leaders decided to take the following steps to overcome their challenges in the five areas measured in the Survey:

- ?? People: improve management skill training
- ?? Infrastructure: Market Calgary's infrastructure advantages
- ?? Capital: Have government encourage venture capitalists to treat high tech in the same way as oil and gas
- ?? Leadership: Support and adjust taxes for early-stage business growth
- ?? Innovation: Provide more streamlined access to innovation programs

Halifax, Nova Scotia

Overall, technology business leaders are positive about the quality of life, social infrastructure and the education system in Halifax. Access to venture capital and interest from venture capital firms are seen as barriers to growth. The outlook, however, remains positive regarding regional innovation potential. Local leaders expect that a mix of government and public/private sector partnerships will help ensure that the required infrastructure is in place to support this anticipated success.

Action Blueprint:

- ?? People: Tie education more closely to employment needs
- ?? Infrastructure: Create a clear vision of our technology future
- ?? Capital: Create an angel investment community
- ?? Leadership: Move from silo mentality to a common branding for the community

Ottawa, Ontario – The Nation's Capital

Ottawa scores high in all growth components needed for the advanced technology sector. Access to capital, skilled human resources, technical infrastructure and leadership are ready at hand. Ottawa is also rated positively for quality of life and social infrastructure. Local firms, however, tend to raid fellow companies rather than rely on colleges and universities for new recruits. Ottawa's challenge today is to put in place the measures to sustain its momentum in the coming decade.

Action Blueprint:

- ?? People: Increase collaboration between industry and universities
- ?? Infrastructure: Re-instate support for broadband
- ?? Capital: Encourage investment related to the New Economy
- ?? Leadership: Create a benchmarking system to give foresight against the global best

Vancouver, British Columbia

Almost 90% of the Vancouver executives reported that they live and work in a vibrant and sustainable community, albeit due principally to neo-Ricardian comparative advantage, based on tourism, a deep harbor and natural resources. Although access to capital is an issue, more than half of Vancouver's business leaders are confident that the city is a global innovation leader, but based on what? Respondents advised the government to adopt an internationally competitive tax regime as its priority to ensure future innovation strength. Vancouver's greatest challenge today is to obtain capital for its continuing expansion.

Action Blueprint:

- ?? People: Identify Vancouver's priorities, and develop cross-disciplinary studies at universities
- ?? Infrastructure: Create physical and specialized infrastructure to energize specific clusters
- ?? Capital: Establish a method to allow individuals to share company risk, and reflect it in tax exemptions
- ?? Leadership: Create industry forums to encourage leadership and vision

In conclusion, understanding the strengths and challenges facing these cities -- and creating an Action Plan to resolve them -- is the most important single task facing communities today. Cities drive economic growth, in every advanced economy. While we often speak of growth in terms of national statistics, growth is in fact a local phenomenon.

Canadian cities contain 95% of all the businesses in the country. In today's global "smart" economy, it is more important than ever that our cities be given the best possible foundation to invent, grow, and generate the tax base on which all our social programs and our structure as a nation depend.

Let's move to another level, that of smaller region or nation states.

The Case of Scotland[3]

Scotland is a small regional economy which is cultural, historically and economically very community based. It is deeply enmeshed, as are many other advanced small and medium sized economies, in an important transformation as they develop and enter the global knowledge economy. Just since 1997 (1997=100), Scotland's Gross Domestic Product has grown to 113.3. However, agriculture, forestry and fishing has rested at 99.3. Production is down to 96. Construction has grown, throughout various business and investment cycles, to 106.1 while services – largely in such knowledge-intensive activities as ICT - have impressively outpaced other sectors by an indexed growth of 122.1 (Q4, 2002).[4] GDP per head is currently $US22,000 as compared with Canada which stands at $US26,000.

With a population of 5.5 million people, 30% are engaged in managerial or professional occupations. Yet it has a long term unemployment rate of 18.5%. The distribution of population is highly variable, with as many as 3300 people per square km. in Glasgow and only 8 in the Highland Council Area. And Scotland is losing an estimate of 250,000 persons to employment related emigration annually. Scotland has an international reputation for excellence in higher education[5] and since 1998 enrolments in ICT fields has increased by 45%. Scotland is home to 20% of UK biotech start-ups, and is the 6th largest equity market in Europe (managing about £350 billion in funds). But between biotech, optoelectronics, telecommunications and semiconductor fabrication, Scotland employs only 37,000 people (out of a labour force of 2.5 million).[6] Sixty-five per cent of Scotland's exports flow into the European Union, but the top service exports arise from non-knowledge intensive activities, such as tourism, (27%), oil and gas (23%), followed by banks, insurance, assurance, and higher education (32%). Computer and software services account for 18%. Thirty eight percent of manufactured exports come from Scottish office machinery.[7] However non-Scottish firms – such as Cisco, Motorola Lucent, IBM, Hewlett Packard and Compaq – dominate the Scottish tech sectors and manufacturing. They tend to be at the lower scale of production and towards the lesser value-added end of the R&D spectrum. Official Scottish documentation notes positively an ability to attract over 200 call centres, even though these have been shown to be highly mobile, low value-added, low paying and lacking in regional staying power[8][7]. Scottish productivity trails Finland, the Netherlands, Belgium, Germany, France and the United States. Its entrepreneurship index shows lower levels than the UK as a whole, and digital connections are two thirds those of London.[9]

Thus it can be succinctly stated that Scotland faces a number of issues as it transforms into a knowledge economy. The central challenges are related to how Scotland can:

(1) attract and retain talented labour,
(2) optimize knowledge spill-overs and value creation, and
(3) attract high value-added foreign direct investment.

All of these issues ask the question 'how can they construct community, and advantage.

In order to achieve this, Scottish Executive (regional government) and Scottish Enterprise have designed a number of policies and programs. It has a series of complementary activities, such as Scotland: A Global Connections Strategy (2001), A Smart, Successful Scotland (2001) and A Science Strategy for Scotland (2002). These documents illustrate the progress that has been made since devolution.

However, all the news is not good news. For example, the science strategy bears a remarkable and undifferentiated resemblance to the science strategies of a number of countries, including Canada, South Africa, Finland, Denmark, the Netherlands, and Australia. It lacks specificity to Scotland's unique capabilities, opportunities and challenges. It emphasizes schools and public awareness, but does not locate itself within the economic context of the entrepreneurial, innovative, knowledge-intensive future of Scotland. Direct comparisons are problematic in that independent data for example GERD/GDP, HQP/capita for Scotland are not yet available. Moreover, there seem to be major disconnects in the production and flow of value-added knowledge. For example Scottish universities, which are world renowned, also show disinclination towards collaboration with local players, especially other Scottish universities. International bi-lateral relations seem to be greatly preferred over multi-lateral research with local industry. The data displayed in Figure One illustrate this tendency.

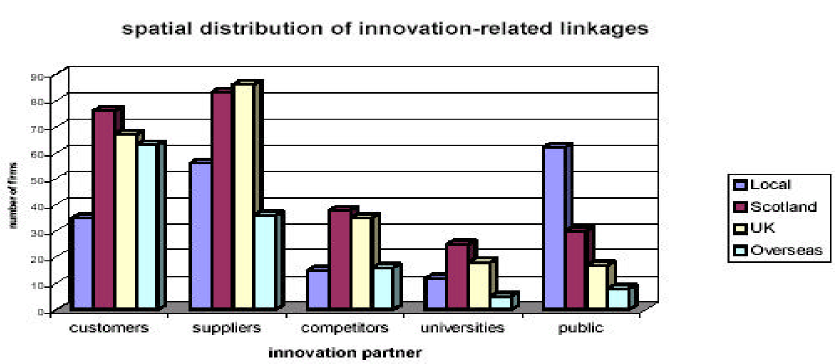

FIGURE 1

Scottish innovators rely more on distributed supply chains – notably distant final customers and on local suppliers for innovation, but not on local competitors, collaborators or universities. This eats away at efforts to construct community.

Put another way, the potential for building scale effects which are often required for competitive, world-playing (never mind world leading), research is largely missing. A similar tendency can be seen in the private sector, where pharmaceutical firms (for example) tend to situate themselves in stand-alone sites (not in science parks or knowledge communities) and deliberately separate research, development and design functions, only to distribute the value-added components abroad.

These types of examples, all gleaned from interviews with university officials, private sector executives and public servants in Scotland with the OECD Expert Panel, suggest that regions facing similar circumstances must adjust their longstanding commitment to a view of trade and production that is based on comparative advantage in which 'value-added' is defined in terms of 'what we have'. Nor can they, given a small domestic market base and population size, follow a strategy which centrally assumes scale and scope of either domestic consumer market or industrial capacity. Instead, they might well consider following a strategy of constructing advantage to maximize the impact of what they do as opposed to what they have.

A key factor we have identified as missing from the Scottish example is the notion of interactions.

Communities Interacting

Much of the popular literature on the global economy has emphasized the growing importance of interdependencies between regions and the speed of interaction because of information and communication technologies. Indeed, many of the citizens of OECD countries are now 'on-line' both at work and at home.[10] They're connected. Scotland and Canada are both nations that claim policy and government program success in connecting their citizens to the internet. But connectivity in and of itself does not lead to regional economic development. National initiatives need careful integration with local networks adding another layer of complexity to our argument.

Some influential contributions to this debate have in fact suggested that the nation state is dead.[11][5] This is clearly a non-sense. We should acknowledge that governance is more complex, involving the play between local institutions (firms, colleges, universities, city halls, local councils), regional governments, national governance bodies (including NGOs) and multinational agencies such as the EU and the WTO. But governance now is also more important.[12][3] Traditional arguments about industrial policy and top-down government intervention in the market place are now moot. But new arguments about innovation policy through which local ingenuity, entrepreneurial vigour and appetites, reach up and are met by regional and national government policies and programs which are adaptive enough to in essence become customized to local needs is now the way forward. Why is this?

Growth

Economic growth is local. National aggregate statistics notwithstanding, the causes – and benefits – of sustainable economic development are embedded in local institutions and people. In other words, if the OECD estimates that a country will experience growth of, say, 4% next year, no one expects this growth to be evenly distributed across every region. Growth is therefore 'lumpy'. Foreign investments, industrial concentration and talent agglomerate in areas that have prepared and culturally conducive institutions. We have seen this repeatedly in empirical studies, from comparisons of Route 128, Silicon Valley and science parks to numerous assessments of clusters and cities such as Dresden, Ottawa, Singapore and Austin.[13][12]

Location

In all of these studies, the readiness of local and regional economies has proven to be decisive. The role of robust and active governance – a matching of 'top-down' policy making and program design with 'bottom up' leadership and action – is key. Governance is no longer about picking winners but is one of backing leaders! Of course, on one level, this simple observation is not surprising given Marshall's work, a century ago, on industrial districts. In this important and well known work, the decision to locate a firm, to start a firm, the demand and supply of skilled labour, the draw on local and foreign investment capital, the inculcation of entrepreneurial drive, and so on… all relating to traditional factors of production….. were seen as key. This is still true. Manufacturing and primary services still matter. Indeed, these combinations of factors of production allowed trade patterns, based on local advantages such as natural resources, to be well understood. 'Value-added' was based on what was 'at hand' (an abundance of wood, marine life, coal, climate, and so on). Much of this, which can be noted here for its emphasis in terms of improvements of manufacture, improvements of technical skills, the development of local value chains, market access and trade profiles, can be linked with the work of the great Scottish political economist, Adam Smith.

Factors of Production

But what has dramatically changed since the time of Smith and his 'invisible hand,' has been a global and critical shift in the factors of production. No longer do we rely, either analytically or in terms of strategy, decision and policy, on simple capital and labour ($Q=f(KL)$ equilibria. Instead, knowledge is now added to the equation. Growth accounting has, since Solow, made knowledge and technology endogenous, not only in the eyes of economists but in the minds of policy makers.[14] Why is this so?

Knowledge

Knowledge is largely a public good. Unlike physical resources, it can be used and re-used over time without losing value. Intellectual property can be transferred locally and internationally without ownership being lost. Uncertainty is high in its production (i.e. research), but this drops rapidly as it is imitated and diffused. Of course, firms' pursue strategies of being world leaders, close followers, or imitators; each carries with it a variety of risk and investment requirements, particularly across industries. This in itself has significant implications for firms and regions. Traditional views of comparative advantage can be overturned by the governance of knowledge and innovation as can sources of advantage based on scale and size of domestic market.

Today, customization, niche production, knowledge and networks deliver increasing returns. The factors of production have changed and the contexts of smaller economies differ. In the cases of the Nordics, Scotland and Canada for example, proximity to the former Soviet Union, the United States, the United Kingdom or the European Union most assuredly have had an important impact on industrial performance and structure. The cases of Australia, South Africa, Singapore and Taiwan, for example, differ again, but not because of their immediate proximity to large markets but more because of colonial histories. All are small or medium-sized economies, lacking scale or scope in the traditional sense. But all are competitive in the global economy based on innovation and knowledge-intensive activities. Thus the question remains on the front burner of decision makers: 'given an uneven playing field in comparative terms and a deficiency of scale and scope, how can we build advantage in the new economy?'

Constructing Community and Advantage

Evidence shows that successful cities and regions understand that multiple levels of policy makers need to ask a series of ongoing questions. These could be stylized in the most simple of ways.

Q1: Why are people 'here' and why would people come and stay?

In Canada's eastern maritimes, the social demographic shows the highest number of universities per capita, the highest educated population and the highest aggregate level of unemployment in the country. This is because, while people are born in Nova Scotia, New Brunswick and Prince Edward Island, they move to Toronto or New York for graduate school and only return to the maritimes for retirement after a successful career elsewhere. From an economic development and innovation perspective, cultural charm and familial ties are therefore not enough. They will come however if there is opportunity for business development, risk capital and market access. Quality of life of course does matter, but for many people this means: is a place safe, can I run (ski, bike, walk), can I get to work easily and inexpensively (this is an issue for Londoners), etc. But from a talent/investment/growth point of view, this is a subsidiary issue.

Q2: Why is investment drawn into a region?

Responses to this question would include: access to smart people; access to infrastructure; access to leveraged funds; access to new and adaptive technologies, footholds into new and potential markets, and; a complementary regulatory regime. Moreover, branding efforts often ring hollow for investors. Where is 'silicon glen' in Scotland or why say 'the tartan tiger'? Incidentally, Canada, Wales and Ireland have also used the 'Tiger' metaphor despite the fact that no one has ever seen a tiger in any of these locales and even Dylan Thomas lamented about a ‘Wales without wolves.’[15] No one is looking for a tiger. They’re looking to invest in entrepreneurial opportunity, in locations that can grow smart firms, employ smart people, and to penetrate world markets. Regional and small national governments often fall into hyperbole. This actually deflects investment, perhaps attracting ‘vulture capital’ instead of venture capital. Gerhard Mencsh clearly understood this when he wrote his book on Stalemate in Technology in 1978.[16]

Q3: What should public decision makers do?

- ?? Recognize, deeply, the nature of innovation. Many do not. Underneath the obvious factors of production, innovation is based on risk, uncertainty, expertise, and networks. Sustainable communities are built on local networks and a spirit of collaboration. Public decision makers can play a critical role in this.
- ?? Engage local industries, university instructors, higher education leaders, not-for-profit organizations, youth groups.

How can these two basic proposals be conceptualized and achieved? One of course could easily fall into the thoughtful area of Schumpeter or Hayek. But practically we can say, ‘let’s look at our city, our region, our future, and our potential as a community.’ OK. We may wish to draw a diagram such as Figure 2.

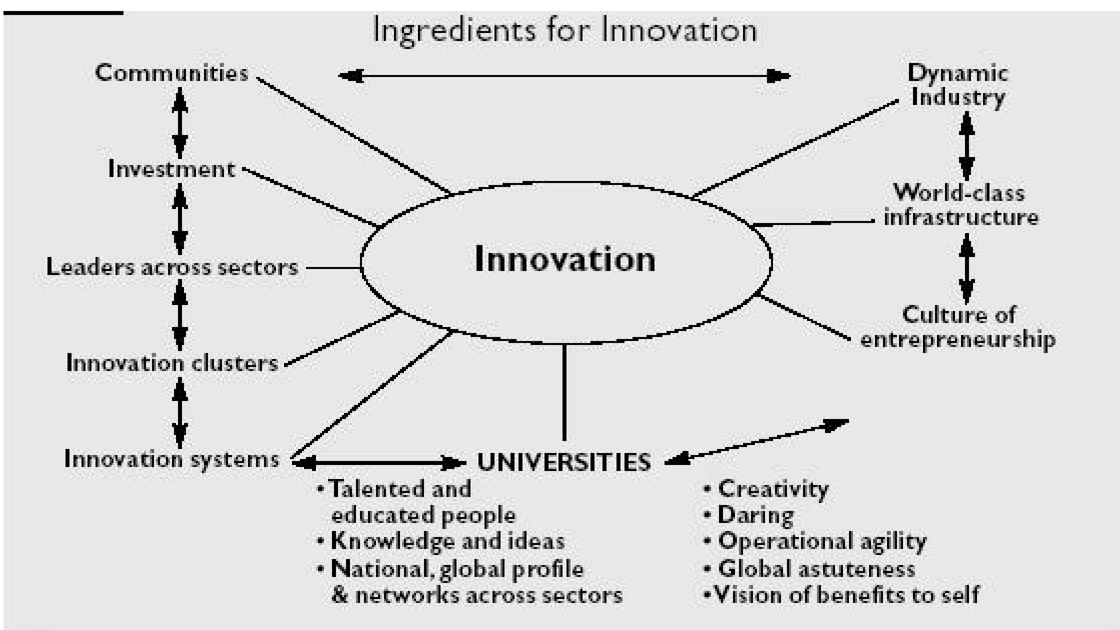

FIGURE 2

Source: Heather Munroe-Bloom, University of Toronto

What does this show? Not much maybe, but it does make us alive to the fact that creating communities and economic advantage is a ‘full contact sport’ and not an dry policy making exercise. For innovation and growth to occur, a region or a city needs collaborative relationships. Otherwise why stay, why commit, why invest? This simple figure actually challenges leaders and decision makers at every level.

One can see how this has been recently adopted, albeit not perfectly, by the City of Ottawa (Figure 3).

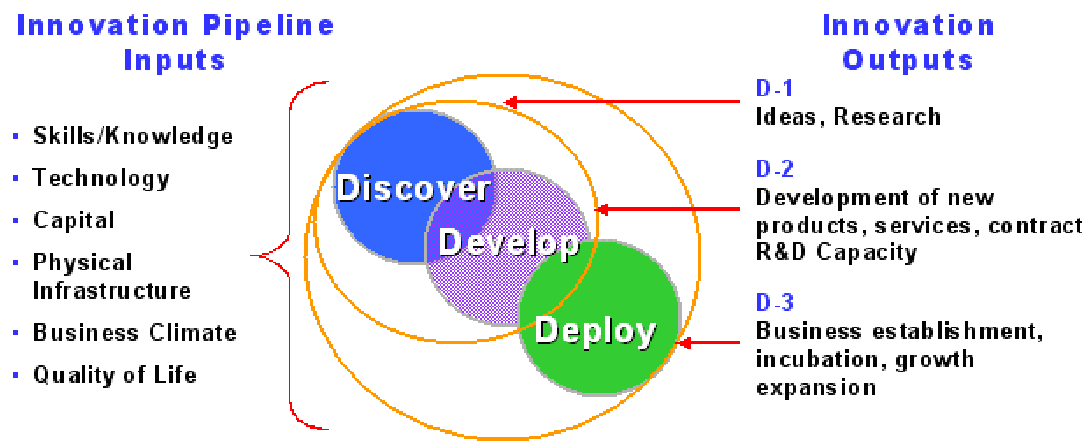

FIGURE 3.

Source: City of Ottawa, 2002

Thus we can draw some issues for regions and smaller states and point to some lessons from Canadian cities that are trying to develop.

A 'smart' region needs leadership from all local actors, firms, universities, government, and non-governmental organizations. This requires engagement, vision and debate in order to see your community as viable and vibrant in the global economy.

The innovative community also needs physical infrastructure, including airports, good roads, local amenities and institutions that offer support for investors and skilled people. Investment today is <u>not</u> going into New Haven even though it has Yale University and it is close to New York City. This is because the city has not dealt with the crime rate, has not dealt with re-vitalizing the downtown core through renovation, and only one airline goes into Tweed International Airport so it is hard to get to. Instead, Newark is getting tremendous investment and inflow of talent because of it's ease of access, proximity to New York (20 minutes), good schools (Rutgers and Princeton are near), and so on.

Coordination Between National and Regional Actors

An important element on constructing communities is one we alluded to earlier; linking regional actors with national policy institutions and frameworks which are becoming a increasingly strong force in research and innovation. However regions and smaller nations differ enormously. This can be seen in the next exhibit.

This indicates that there only two countries with a strong interaction between the national and regional level: Sweden and the UK. In Sweden the entry of the county as a regional actor is quite new, and at the same time these counties have little powers and funding. The picture in the UK is more complicated with some regions having had a strong independent position (Scotland and Wales) in innovation, whereas the English regional policies such as the recent Yorkshire Forward initiative are newcomers to this field.

In 1998, the Swedish Government introduced a new regional industrial policy. Based on the prevailing conditions of each individual region, the aim of the policy is to stimulate sustainable economic development that will spawn more companies and help existing enterprises expand. At the same time, regional 'growth agreements' were also introduced to facilitate implementation of the new policy.

	Co-ordination national regional
Canada	?? Strong State involvement in knowledge production, but concentrated in Ontario, B.C. and Quebec ?? Little co-ordination between federal and regional policies
Denmark	?? Activities of regional actors dispersed over counties and local communities and often sub-critical (small budgets) ?? National level attempts to help co-ordinate within and between counties
Finland	?? R&D heavily concentrated in few areas (Helsinki, Tampere, Olou) ?? Activities of regional actors dispersed over counties and local communities and often sub-critical (small budgets) ?? ST&I responsibilities very centralised at national level
Ireland	?? ST&I responsibilities very centralised at national level and implemented by regionally allocated agencies
Sweden	?? Strong co-ordination national regional Research and innovation strategies ?? Regional Performance contracts
United Kingdom	?? The Regional Development Agencies are a relatively new actor with increasing innovation budgets ?? Aimed to deliver research and innovation services from DTI ?? Strong interaction with DTI ?? In Wales and Scotland strong Development Agencies who work quite independently

A growth agreement must be primarily based on a fundamental analysis of the business development prerequisites in the region. Based on the analysis, a development program is formulated aimed at utilizing the identified opportunities and satisfying the need for measures to promote business sector growth.

According to the Swedish Ministry of Industry the encouragement of a cross-sectoral approach to regional growth and development means that multi-sectoral collaboration should also be intensified between the various Swedish ministries. For this reason a special committee consisting primarily of the state secretaries from various ministries has been set up. Most of the ministries are represented on this committee, which has the overall responsibility for co-ordinating issues relating to growth and employment policies within the Government Offices.

When the new UK government came into office in 1997, it was committed to create a new level of regional administration across England. This was both an attempt to emulate the economic success achieved in Wales and Scotland and provide some psychological balance to offset the creation of the regional assemblies in NI, Scotland and Wales. The new regional development agencies (RDAs) were given an economic development brief by London. Over time, the RDAs have seen their 'innovation' budget grow. A series of national innovation funds (Competitiveness Development Fund, Innovation Clusters Fund, Regional Innovation Fund) has been launched, each one larger than the last, and each one more open in terms of the conditions set by the Treasury and DTI (the source of the funding).

As the RDA innovation budgets have increased, so the central DTI budget has been squeezed to the point that its enterprise budget (£330 million) is almost entirely expended through regional delivery channels. In practice, central government expects a growing share of innovation support activities to be determined and delivered locally (most RDAs now have a Science Council).

The Innovation Liaison group (meets quarterly), which is coordinated by the DTI and involves officials from London and the regional Government Offices in discussing policy needs and instruments (to minimize overlaps and underlaps) has been opened up to the RDAs. This has proved popular and there is talk of strengthening the mechanism through the creation of a high-level steering group with its own budget.

Some Observations for Strategy and Global Business

Rather than develop a formal conclusion to this paper it is perhaps more appropriate to briefly summarize the argument and make some observations on the implications of our analysis for strategy makers in firms.

At a very basic level we suggest that economic growth is lumpy and occurs within countries and regions but is actually centered on cities. We argue that 'smart' cities i.e. those with good infrastructure, smart people and capital are capable of generating significant economic growth as traditional sources of competitive advantage, based on national sources of comparative advantage or on scale benefits disappear as the global economy shifts.

Instead we suggest that policy makers turn their attention towards constructing sources of competitive advantage. The process we envisage, and the basis of our questions is focused not only on a policy debate between regional city and national governance systems, itself quite a distinctive idea, but also with other interested stakeholders; most notably with sources of inward direct investment i.e. firms and their managers.

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End Notes

[1] Robert D. Putman, "Bowling Alone: America's Declining Social Capitall", *Journal of Democracy*, January 1995, p.65; This valid line of argument is less successfully amplified in his *Bowling Alone: The Collapse and Revival of American Community*, Touchstone, New York, 2000.

[2] See John de la Mothe and Gilles Paquet (eds.), *Local and Regional Systems of Innovation*, Kluwer, Boston, 1997; John de la Mothe and Albert N. Link (eds.), *Networks, Alliances and Partnerships in the Innovation Process*, Kluwer, Boston, 2002

[3] This section is based on a report prepared for the OECD in January 2003

[4] www.scotland.gov.uk/stats/bulletin/00234-00.asp
[5] In the last research assessment exercise, six Scottish departments received the highest '5-star' rating.
[6] This number is imprecise as the Knowledge Exchange also notes as an aside that the electronics industry employs 41,000 people but this figure does not jibe with the otherwise stated figures.
[7] Scottish Key Facts compiled by the Knowledge Exchange (Glasgow), 21-11-02.
[8] cf. Richard Nimijean, "St. Johns New Brunswick as an Emerging Local System of Innovation", in John de la Mothe and Gilles Paquet (eds.) (1998), *Local and Regional Systems of Innovation*, Boston, Kluwer.
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[11] See for example Kenichi Ohmae *The End of the Nation State: The Rise of Regional Economies*, Free Press, New York, 1995.; or Kenichi Ohmae, *The Invisible Continent*, Harper Business Press, New York, 2000.
[12] John de la Mothe (ed.), *Science, Technology and Governance*, Continuum, London, 2002.
[13] See Saskia Sassen, *Cities in a World Economy*, Pine Forge (Sage), Beverly Hills, 2000.
[14] No longer is technology seen as $\overline{T}$ as being equally accessible over time and space, to all 'rationale actors' who possess 'perfect information'. See any of the textbooks on macroeconomics by N. Gregory Mankiew.
[15] Politicians have recently referred to Canada as the Northern Tiger, Wales as the Welsh Tiger and Ireland as the Celtic Tiger. Even India is having trouble holding on to its real tigers!
[16] Gerhard Mencsh, *Stalemate in Technology*, Ballinger, New York, 1978

Culture and Business

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Abstract

There is a revival of interest in the role of culture in many areas of scholarly endeavour, from history to business. But the meanings of the words are often generic and not very accurate. In this paper we try to deepen this understanding on the subject by reassessing the definition of culture in different context. Starting with the definitions, we wide to similar and related concepts and meanings, which are used nowadays in many areas of interest including business. A substantial part of the paper is devoted to considerations regarding the time impact of culture. Finally, we look into the theoretical instruments developed in order to explain some recent cases from the fields of historical and business studies.

I. Introduction

The role of culture as a motivation factor for human activity is nowadays very much reappraised, with the economic area of interest not excluded. But the reciprocal influence between cultural background and human activities may be complex. Therefore, it is not without importance to try to reassess the subject as a whole. The present paper will try to carry out some steps in this direction, considering the following aspects of the problematic: [a] culture defining; [b] building stones of culture; [c] consequences for business and other areas of application; [d] discussion of cases from the business world and from other areas of human endeavour.

2. What is Culture?

In order to define culture we can start with semantics. This is useful, because it gives us a point of view on the evolution of the concept by means of the evolution of the word. The word derives from the Latin term "colere" , bearing past participles "cultum" and "cultus", meaning "to cultivate", "cultivated".

2.1. Agriculture

Hence, the first insight goes to agriculture, farming. Agriculture means the transformation of earth's surface or soil, from one kept "wild", like a forest, prairie or desert, into a worked out area, generating crops.

2.2. Education

If we use the term without the farming context, singled out by the prefix "agri", then we have in mind not a physical soil, but a human one, i.e., what classical thinkers called soul, and modern ones prefer to call brain and/or body of a person. The term "personal culture"[i], for instance, is a widely diffused concept. Personal culture is obtained through the process normally called education. Education means not leaving a person in a primitive or wild condition like a desert or a forest, but transforming him or her by means of a behavioural discipline and informing by knowledge. Similarly as a cultivated soil, also a cultivated person is expected to bring some kind of crops, as a result of the cultivation. Of course, cultural crops have a wider diapason than agricultural ones. They can stay in any area of human endeavour, from art, to science, political results and other kinds of spiritual achievements. Personal culture includes also physical culture, where "crops" refer to body achievements, like body form, sporting activities, strength, health.

2.3. Colonization

From the Latin "incolere", a derivation of "colere", comes "incola" which means colonizer, settler. Also here the meaning is easily understood: given an area in wild uncultivated conditions, people move in, settling and becoming colonizers. Originally, it has a benign meaning, considering that colonizers are doing something positive to the area, improving its conditions. But cultivating often cannot be done without exploiting, therefore, especially today, colonizers and colonizing got also a negative popularity.

Wild area colonizers settle down and some of the settlements grow to the size of cities. In Latin the city inhabitant was called "cives", which has approximately the modern meaning of citizen and generalizing becomes civilization, a term with a meaning not far from culture. There is a difference between the two terms, civilization refers more to the instrumental part of the meaning and culture is connected more with the informational part of it. As a matter of fact, the two terms overlap very often

3. The anthropological point of view

Between sciences, Anthropology is considered as the "science of man", but, as a matter of fact, it is the science of culture. Man indeed, may be divided in two parts, one merely biological, by which it is part of the so called biosphere, or biological world. In that sense man is similar to his biological relatives, plants and animals. But, as a difference to the biological part, man is also part of another realm, the realm of thought and spirit, the noosphere, as it was called by the French philosopher Teilhard de Chardin[ii] [iii].

The great modern discoveries of the DNA and of the genetic code, connected with the biological aspect of man, make it possible to reach a systemic generalization, regarding the meaning of man and culture[iv]. Modern discoveries have revealed that the genetic code is nothing else than a "script" or "information", we can also say, a "data base", or a "program", of the given biological item. The same is true for all living beings. We can generalize this by saying that the whole biosphere is constituted of information codified in the particular biological code. The evolution of this code in long epochs brought to the formation of all living subjects on earth's surface comprised also man. In this sense man is a part of the biological realm or biosphere. The biological kind of writing information has many advantages: we can see it by the development and existence of billions of living species and individuals on earth. But it bears also a remarkable disadvantage, which can be very easily envisaged: if a transformation is asked for by evolution, it can be obtained only by creating new species in a physical sense. For instance, if there are defects on a species, it can be changed only physically, taking a long effort to get it.

On the other hand, man has the possibility to gather and transform information in a way which is much more easily achieved without the mentioned physical disadvantage: he does it by the help of organs where information can be stored and transformed with less effort than by the genetic code. They are the brain and the memory as part of the brain. As at the birth of the individuals, memory is empty [or almost empty]; it must be afterwards filled with information of any kind. We can call the information accumulated in a man's memory, using the term culture. Namely it is not only a random gathering of information, but it is structured in many different ways. In order to obtain the ordered accumulation of information we need the process of cultivation – education. Consequently, we can call culture the ordered information present in man's memory, used as a program for activities. Culture is therefore the part of the information regarding man, which is present in man's memory, but not the one present in his genetic set. This is true for each individual. Anthropologists use a similar categorization of culture, as we followed above. They start with the biological base of mankind; speak about language learning, enculturation process, social, technological and ideological systems. This last part is particularly important. Inside this part we find also the religious relevance of culture. A most general term to signify religion is "cult", which is derived from the same root as culture.

3.1 Culture as a collective memory

Culture also has a very strong collective impact. This comes from the fact that individual memory has limited capability, and single persons specialize in different activities: therefore the one gathers more knowledge in one sector and the other one in the other. Not a single man but all together have the total memory of things. Culture is therefore both individual and collective. Between the whole and the individuals, subcultures can be envisaged: cultures owned by smaller groups of people than the whole, like for instance, single nations or a business. In such cases we speak of group culture. Culture is a pattern of beliefs and expectations shared by people[v].

3.2 Culture in Business and Management Sciences

Management sciences take its knowledge of culture from Anthropology. For instance, one of the branches of Management, International Marketing, offers normally to students a full chapter regarding culture[vi] subdividing it in the following building blocks: Technology and Material Culture, Language, Aesthetics, Education, Religion, Attitudes and Values, Social Organization, Political – Legal Aspects. This categorization is again similar to the one which we already saw above.In the business area culture is mentioned at several points of the subject. A very important part of the business system is the Marketing System. Hyperbolically, but effectively, we can say that it is the weaponry used by business to conquer customers and markets[vii]. Therefore, it is undoubtedly, a central part of the business system, even if it is not the whole of it. The elements of the marketing system are shown in Fig. 1 As elements of the system we can enucleate the active variables, or Marketing Mix, called also the 4 Ps:

1. Product and/or Service
2. Price
3. Place or Distribution
4. Promotion

And the passive or environmental variables, categorized as follows:

1. Macro:
1.1. Demo – Geography
1.2. Income and its distribution
1.3. Policy and laws
1.4. Culture
1.5. Technology
1.6. Natural Environment
2. Micro:
2.1. Suppliers
2.2. Middlemen
2.3. Corporate Culture
2.4. Competitors
2.5. Clients.

Considering in detail the above system, we can see that culture is a variable, mentioned two times in the listing. It is mentioned at point 1.4. as a macro variable and at point 2.3. as a micro variable of the environment. Point 1.4. references to an individual impact of culture: customer behaviour and his buying decisions. The business actor must know the cultural impact, if he wants the customer to take into account his offers. Point 2.3. refers to culture as a collective impact inside the company, influencing business decision making, regarding active variables of marketing, i.e.: the mix: product, price, distribution and promotion. Some companies prefer to do business with people they know[viii].This is at a first level of influence. But culture influences also the other Marketing variables, even if not in so direct a way. For instance, the geographic and demographic characteristics of the customer depend in part also on the cultural characteristics of the population.

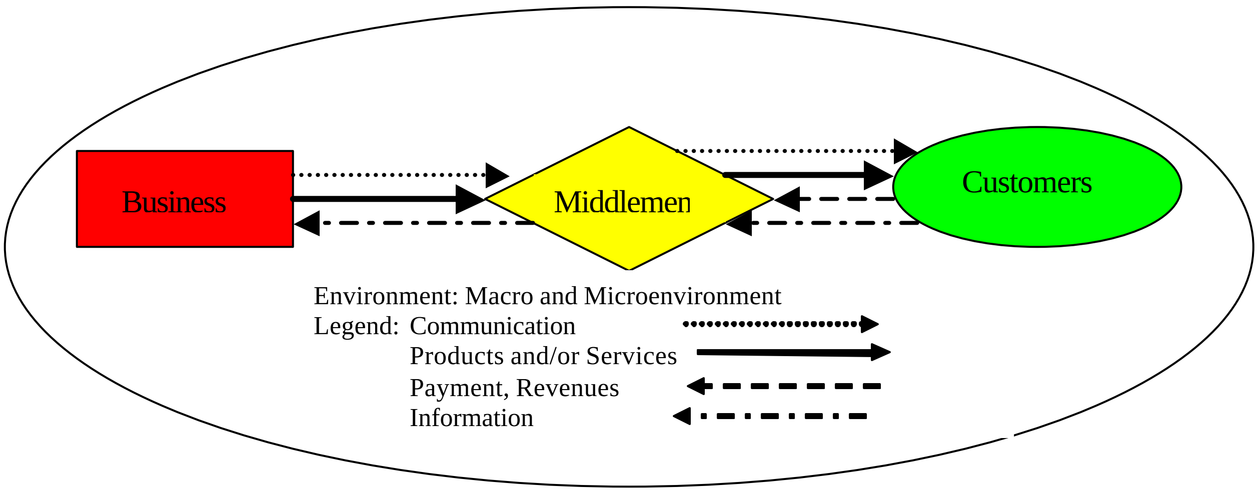

FIG. 1 THE BUSINESS MARKETING SYSTE

Let's consider only a trend, typical for Mediterranean areas, where most people live clustered in localities, whereas populations with cultural characteristics typical for Northern areas, either in Europe or in America, often prefer isolated home dwellings. The two types of culture have different consequences on customer demand. For instance, people living in isolated homes need different furniture, than people living in flats. Also income depends on culture: there is a positive correlation between income and education level, which is connected with culture. Here, again, culture has an individual impact.

The policy of a country and her laws depend on the kind of the prevalent local culture. Similar considerations could be thought also of other variables taken into account by the marketing system, like natural environment, suppliers, middlemen, competitors and others.

Hence, it is possible to state that culture stays in the forefront of some business variables but to a stronger or lesser extent it stays in the background of almost all of them: the business decisions, both from the point of view of offer and demand, are to some degree connected with player culture. It is relevant therefore, to understand with more detail the role of culture in the system.

3.3. Language

In order to create the collective culture, and when it is created to participate to it, language is needed for the sharing of information between individuals. A language is an ensemble of sounds with conventional meaning. The conventional aspect of language can be deduced by the fact that we don't know a foreign language, as we don't know the conventions at the root of it, but with some effort we can learn them. Language has not only a semantic impact but also a structural one: it is a collection of sounds united in words by using semantic and syntactic rules. Language is often defined as mirror of a given culture[ix], as it contains meanings and structures unique to the culture or subculture. There is a trend between scholars therefore, to study cultures mostly by studying languages. Language is very important an expression of culture, but it is questionable if it represents and exhausts all the building blocks of a culture. Similarly to subcultures there exist also sublanguages, for instance, dialects.

Hall[x] for example, divides cultures in two groups: low and high context. This idea has to do more with the use of language in a given culture, than with the semantic and syntactic aspects of it. By Hall's view low context cultures are those in which speakers express everything they like to tell with words and phrases of the language. So the receiver of the communication has just to listen to the words to know what was communicated to him. In high context languages to the opposite, words and phrases don't suffice. It is important also to observe the context in which things are told, stresses, accents, posture of the body, gestures. The receiver of the message has to evaluate all this aspects together in order to get the full meaning. Of course, in every communication process the context has a role, but in certain cases it may be paramount. These are the cases pointed out by Hall.

3.4. Artificial memories

One of the most important achieves of mankind is the creation and development of artificial memories. This was possible with script invention. Historically we can list in sequence the following means: wood, clay tables, stone, papyrus, parchments, books, magnetic tapes and disks, CD ROMs, DVDs and the related script systems: pictograms, ideograms, hieroglyphs, alphabets. Artificial memories have had an enormous impact on the widening of individual and collective culture, as they can store more information than the single brain memory; all of them they are storing the whole of culture, indeed.

3.5. Time dimension of culture

The justification of the time dimension of culture comes from the following consideration: cultivation is not possible in one instant, but it takes time. Only in a year period a wild soil can be brought to crops, many years are needed to colonize an area, even longer periods could be asked for, in order to educate persons and/or groups. The total culture of mankind has been accumulated during tens of thousands of years. In order to show this aspect, we will treat culture in its collective aspect. Hence, we will not speak of the culture of one person, but of group culture, or even mankind as a whole, treating it from a historical point of view.

History of culture could be carried out through a complex and detailed description, which would take not an article, but many books. But, I believe, it is also possible to make a simplified synthesis, which is lacking on details, but offers some basic patterns, in order to get useful comprehension of the basics of the phenomenon. In order to treat this aspect, let's start with some technological considerations. Already Karl Marx[xi] stated that civilizations are induced by what he called "production means", meaning, as a matter of fact, that every particular form of culture or

civilization, depend on the measures and instruments people use for their survival. With other words, we could say, that technology in the wide sense of the word, is compelling a given culture to develop within some limits given by the technological methods and instruments used by the given community.
The technological consideration is at the base, explaining the material forms and aspects of a culture. But men living in given conditions develop the ideological super structure, which is also something typical for every kind of culture and between them an important role is played by the form of religion, which is particular to a given culture or civilization. Therefore, I believe that a culture can be determined by its material means, from one side, and by the description of its basic ideology or religion, from the other. Technology is needed for survival, but why is religion developed by every culture, as it seems not to be needed for survival? An explanation could be the following one: by means of its material instruments men of every culture are trying to survive in the environment where they are dipped in. The technological means, representing the material part of the particular culture represent the survival means from one part, but the limit to the feasible from the other. The limit is a border to the still possible and to the impossible. Reaching this border by a man or a collective the maximum success is obtained, but also failure and death are close: it is a border between living and not living, which can be fully bridged only by ideological projections. Religion is the part of culture dealing with what happens on this border and on the other side of it, where it is not possible to go in the earthly form. To describe it we use again a Latin term: "transcend ere", meaning, the things existing on the other side of the culture border.
The border exists for every culture experienced until now; therefore every culture builds up its form of religion. The imaginative forms of it depend on what factually every culture experiences on this border. From the technological and ideological point of view, human history, as a whole, can be subdivided, by a first approximation, in three large periods: the period of nomadic tribes, the period of agriculture and that of modernity[xii].

3.6. Nomadic period

In this first epoch of history, people were compelled to move through the territory for the simple technological reason, that after a time they exhausted the crops offered by nature alone in a given area. When products were exhausted, they had to move from the old area into a new one, where crops were abundant or still present. This is due to the fact that in this period, men were able to use only the crops offered by nature alone, the so called natural resources. They were therefore bound in a given place to the existence of them. To survive and to be a winner in such an environment they had to organize themselves in small tribes under unitary command, as quick decisions were winning over slow moving. The positive aspect of such kind of life was given by logistic freedom either for the tribe as a whole, as also, to a lesser degree, for the individuals. But the freedom had to be paid off by risk. Risk came at the border, which we mentioned before, and was mostly provoked by environmental forces. The environment was to a large extent inimical due to natural forces: wild animals, catastrophes, battles with competing tribes for the few resources. Religion was a projection cross this border related to the dangerous forces lurking there, that couldn't be tamed: animals, woods, rivers, mountains and similar. At the beginning of human history, all people lived in nomadic conditions. Afterwards the number of nomadic tribes dwindled, but even nowadays we can find some population examples of this kind of culture.
Another important point not to forget is the following one: there was an evolution in time of the nomadic kind of culture. At the beginning we have very primitive forms; at the end we find more complex and sophisticated ones. I think that this evolution had to do with the improvement and risk reduction of nomadic life, using the technological survival means at disposal to mankind at this evolution step.

3.7. Agricultural period

Agriculture was initially possible only on particular places. This is due to the technological fact that soil needs to be fertilized, if crops should be obtained again in time. Agricultural crops exhaust soil very quickly, and we cannot continue to plant in the same area, but have to move further, giving again place to a kind of nomadic behaviour, even if to a lesser extent than the original one, bound to gathering and/or stock rising. This kind of agriculture is an intermediate form between the nomadic and the agricultural way of life. But there are certain particular areas, especially along large rivers, like Nile, Mesopotamia, Hindus and others, where soil fertilization happens naturally, mostly by flooding periodically. These were the first places on earth where it was possible to plant crops on the same area over and over in time. Here, for the same reason, people could settle in a steady fashion. They didn't have to move again and again, but just stay and work on the same place. This technological situation created a new cultural phase, which removed the risk of the nomadic life, but it had to be paid off by another undesirable effect: work compulsion for the vast majority of the population and hence the loosing of individual and/or collective freedom. This is due to the fact that through simple soil cultivation one person can produce only a little more of what he needs for survival: only a surplus which is relatively small. Seen from the point of view of the collective, hence we have the following condition: the large majority of the population must be applied on doing the agricultural work in order to guarantee subsistence of the group as a whole and in order to create the surplus. If we want more exceed, more people must be engaged in work. This is the reason why rural societies organized themselves mostly in large sizes, differently than nomadic ones.

The other aspects of this kind of civilization comes out from the use of the surplus: namely, it makes possible to free a small share of the population from subsistence work, feeding also some trade flows, exchanging crops for products not produced by the given population. Agricultural civilization develops a basic injustice between its members, as most of them are compelled to carry out the basic work and a small number is exonerated of it. But there is little choice to this situation. This is again a border situation, which people tried to cross by transcendence. From a practical point of view it worked very logically: the elite started to justify its being spared of the worst labour, by involving patron deities. Gradually a civilization evolved where priests were dwelling at the centre of the elite group and on wider circles there were to be found other kind of specialists not directly involved in the hardest activities: scribes, accountants, military, teachers, and merchants, all of them needed by the given community for special reasons. The social structure of such societies can be illustrated as a hierarchic pyramid[xiii] with a few people on the top and many at the bottom. Such a society needed religion in first place in order to give a sense to the existence of the pyramidal structure and in order to transcend it.

I understand that this kind of analysis is very similar to the one developed by Marxists in 1800. The difference is maybe only in the fact that Marxists thought that the ideology permeating the agricultural societies was mostly a lie, used by the elites to quiet down the bulk of the population. But I think that it was something more than a lie, it was a need of the society, as a consequence of the basic technological conditions. It was an ideological superstructure needed by the agricultural civilization to maintain its overall equilibrium.

Again, like we saw it for the nomadic tribes, we must say here that also agricultural societies evolved in time: the first ones were primitive if compared to the late ones. For example mankind learned how to extend farming also to areas without natural fertilization of the soil. With time people learned how to produce more and more surplus, liberating more and more persons from farm compulsion. Some two, three centuries ago the majority of mankind lived in the conditions typical for the agricultural society, nowadays this kind of culture is still present in vast areas of the globe, but it is minority and it is loosing ground to modern society.

3.8. Modernity

The contrast between the agricultural civilization and the modern one is what we normally describe as third versus first world, developing versus industrialized countries, South versus North of the equator. In all these areas, as such third world, developing countries, south of the equator, we observe one common indicator: a higher percentage of population involved in farm activities.

Modern culture started to emerge in Europe in 1500. It is not easy to explain what exactly modernity is in contrast to the older forms. The reason is that stages 3.1. and 3.2. of development stay in a historical perspective and we see not only the single trees, but also the wood as a whole. We are not in such a fortunate position with reference to the modern epoch. As far as material culture is concerned, we can say that there was a tremendous evolution of science and technology, making it possible to create survival surplus in unlimited size. In a first world country, for instance, some 1 to 2 percent of the population may create agricultural surplus in such quantity that it is enough for the rest 98 percent of the population, and there is also enough for export. Machines substitute almost the whole heavy work needed, once performed by hands. If you need a trench around your house, you just call a company with machines and in few hours it will be dug out. Mesopotamian farmers 4.000 years ago had to do it by human force and simple instruments. The consequence of it is that almost the majority of the population of a modern country is living in circumstances once typical for elites. It is interesting also what happened to religion: it lost its social importance and it acquired a new one, very individual and intimate. The forces unbound by modernity are so vast and strong that we don't see very clearly a border imposing a limit to its development and hence the need of religion in its original form seems to be lower than once. The impression is that everything can be solved without the intervention of some transcendental entities. But we must not forget that modernity started with a religious revolution: the demand of freeing Christianity of the forms acquired during the agricultural epoch, benchmarked to the pure evangelical standard. Religion didn't disappear, because also modern culture didn't solve all human problems. Also modern culture has borders, even if we don't see them so clearly as those of the older cultures.

What we can observe is that modern culture is winning ground to the older ones. It is conquering heads and hearts of people still living in old kind of circumstances. The phenomenon is apparent from several indicators: mobility patterns of emigrants abandoning areas where modern way of life doesn't advance quickly enough, sudden take-offs to modernity in countries with traditional ways of life[xiv], wars which can be more and more explained as clashes of modern and older civilizations[xv].

3.9. Modern culture and business

Development, or better, explosion of international business is tightly related to two conditions: fast advancement in field of communications and in field of transportation. Development of communication and transportation permitted quick transfer of information and people. Physical proximity did not matter any more. Companies went outsourcing in order to obtain cost savings, while technology permitted them to maintain tight control of subsidiaries.

On the other hand, enhanced flow of information created another effect. It made possible that people from very distant part of world have access to the same information, what led to convergence in general trends in politics, sociology and economy. On the first spot, it seemed that culture started to lose importance as an issue in international business. But, it is not so. In the field of business, for example, it could be said that every culture has developed through its own history some specific and unique insight into the managing of organisations. At the same time, any single cultural model may become pathological when pushed to its extreme. There lies undiscovered opportunities and threats of international management[xvi].Comparative research shows that managers from different national cultures hold different assumptions as to management and organisation. These assumptions shape different value systems and get translated into different management and organisational practice. The assumptions and values of the local designers could be highly meaningful and effective for the home country, but possibly meaningless, confusing, and ineffective for another country. In order to build, maintain, and develop their corporate identity, multinational companies need to strive for consistency in their ways of managing on the world-wide basis. Yet, and in order to be effective locally, they also need to adopt those ways to the specific local cultural requirements. In other words, while global nature of the business could call for increased consistency, the variety of cultural environment may be calling for differentiation.

3.10. The Hofstedian model applied to the historical approach to culture

An interesting contribution to the differences between cultures was given by Geert Hofstede[xvii]. He pointed out some variables which distinguish different cultures: [a] hierarchic distance, [b] uncertainty control, [c] individualism, [d] masculinity and [e] orientation to the long or term in achieving goals. It is easy to see that they differ a lot between the three cultural models hitherto proposed. Table N.1. is showing these differences.

TABLE 1. CROSS SECTION BETWEEN THREE HISTORICAL, CULTURAL AND HOFSTEDIAN VARIABLES.

Cultural models	[a]	[b]	[c]	[d]	[e]
Nomadic	low	low	Middle	high	low
Agriculture	high	high	Low	middle	high
Modern	low	middle	high	middle	low

If we are not sure what the characteristics of a given culture are, which we are studying, we can use the Hofstedian model in order to characterize it.

Case discussion

Readers of this paper will probably say that the evolutionary process of culture development described here is to sketchy, lacking of a full wealth of details, which are very important to have a true picture of what happened, and I would mostly agree with such an opinion. The proposed model offers only some basic considerations, which would need to be developed in many more detail[xviii], in order to explain the relationship between old and modern culture and all the happenings in between and in particular places. But even in such a wide painting the basic ideas, coming out of the picture can help to explain present facts either in history as a whole, or in Business Management, as special discipline. I would like to make some examples:

Some Authors sustain the thesis that modernity is also the end of history[xix]. In my opinion this thesis can have an explanation by means of the historical cultural models proposed above. The perspective of traditional history was mostly that of nomadic and agricultural worlds. It described the situations and the changes of these worlds. These changes happened mostly through wars between nomadic and agricultural realms and between agricultural realms themselves. In these species of wars there is mostly the telling of how one king won against another one, conquering his realm. Historical changes had very much a physical character. In modern times changes remain, but their character is becoming step-wise different, less and less physical. In this sense, for instance, I believe that World War Second was fought with modern means, but with old ideology. Hitler, for instance wanted to conquer physically the so called "Lebensraum"[xx]. The idea is a typical old time culture baby. Modern conquests are different.

As I mentioned above, it is not easy to show the characteristics of modernity, because we lack of historical perspective. Our time is still a blend of old and new, and these elements are mixing before of our eyes. But an example of the new may be the creating and the developing of the EU. Hitler wanted to conquer Europe but couldn't realize it with physical means, whereas it is nowadays happening under our eyes, by new means. The conquest is not based on armies but on bureaucracy and economy. Compulsion didn't disappear, but changed in character. If the old kind of wars were considered as quintessential to history, history nowadays would change so much, that it is possible to state that it disappeared. Modern conquest is a war without casualties, but with much paperwork. The point is that it is probably hard to write a historically interesting book of this kind of happening, as we are used to Napoleonic style of wars.

One of the main problems of International Marketing and of the so called problem of Globalisation is the following one: should we create standard products for the whole world, or is better to adapt them to local conditions? In the first case, we globalise strictly, in the second we accept the presence of local cultures to some degree diverse. The question has an economic payoff: if we go standard, we get economies of scale, reducing costs per item, but we may lack in depth of market conquer, addressing only small market segments in a given country, in the second case, we may reach more in the deep and hence sell more, but the product must be transformed opportunely with more costs. The right decision depends on many factors, but the final answer to the question depends also on the evolution of the market segments in a given country. Also in the most traditional areas we have some islands where modern culture tends to emerge, mostly in the cities, gradually catching out the old ones, which are mostly bound to the countryside. If the advancement of modern culture in a given country is dynamic, for instance, it may be better to plan the introduction of standard products. If it is less dynamic, the decision maker must consider the choice between the alternatives of skipping the particular market, or maintaining it in the international portfolio, but adapting the products to local culture and hence bearing higher costs to that regard.

The difference between old and modern culture may be used also to explain Hall's difference between high and low contest languages. In the agricultural stage there was a trend toward pyramidal hierarchy, as we saw, and in parallel with it also to crystallization of social behaviour. It is possible to advance the hypothesis that high contest languages depend mostly on this kind of background. Modernity brings a lot of innovation, asking for a language used as a mere technical communication mean, mirroring also in culture.

An interesting application of the culture explanatory model is reported recently from the area of Production Management. VW, one of the large world car corporations, adopted recently in its German factories an advanced method[xxi] of job organization in order to contrast the trend of job emigration to CEE[xxii] countries. The internal corporation bench-marking was given by a factory in Bratislava, Slovakia, where wages were much lower than in

Germany and work done of comparably good level. Without changes in flexibility of work application, factories would stepwise emigrate from higher to lower wage areas, creating unemployment and other negative economic consequences at home. In order to save work places in Germany, even with the high local wages, a new, complex method of work implementation was devised. It enhances very much productivity, making it possible to invest at home. It is one of the secrets of the economic recovery, now on the horizon of German economy. The VW general manager was asked if it would be possible to shift also this more complex production method to CEE[xxiii] countries. His answer was negative: the method is so communication rich that it is almost impossible, in his opinion, to carry it out with work force not understanding and using German language. It is an appraisal of the role of culture for successful management.

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[xii] A similar point of view is expressed by several modern Authors. See for instance: Ernest Gellner (1995), Nationalismus und Moderne, Hamburg, Rotbuch Verlag, pp.63, 100; Eric J. Hobsbawm (1996), Nationen und Nationalismus – Mythos und Realität seit 1730, Deutscher Taschenbuch Verlag, pp.: 121, 193; Karl W. Deutsch (1975), Nationalism and Social Communication. An Inquiry into the Foundation of Nationality, 2nd ed., Cambridge MA: MIT Press.

[xiii] This is maybe the reason why the agricultural societies of the past so often used a pyramid or a semi pyramid in building: Egyptians, Maya, Hindu and others.

[xiv] The most recent example is China.

[xv] See for instance the famous book: Samuel P. Huntington (1996), The Clash of Civilizations and the Remaking of World Order, New York: Simon & Schuster, 367 pp.

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[xviii] For instance, also the old cultures, the agricultural one and the nomadic had an internal evolution. For example, the latest agricultural realms were very different from the earliest ones and the same is probably true also for the nomadic realms.

[xix] See, for instance: Francis Fukuyama (1991), The End of History and the Last Man, http://www.sais-jhu.edu/faculty/fukuyama/books_frame.htm

[xx] Extension of geographical space needed for the survival of a nation.

[xxi] Dietmar Hawranek (2003), Die Job-Maschine, Der Spiegel, Nr. 37, pp.: 102, 114

[xxii] Central East Europe.

[xxiii] Cfr.: note 22

The Management of the Corporate Culture

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Abstract

The change of the corporate culture is one of the key elements in transformation of companies in Slovakia. In this article are compared the theoretical basis of the corporate culture management with the practical experiences of companies. The most important issues are outlined in the corporate culture management model. The aim of the corporate culture management is strategically appropriate corporate culture, which enhances the company's performance. Corporate culture is a very important success factor of the company, influencing both "soft" as well as "hard" areas of the company. Company should deal with its corporate culture when there is a difference between strategically appropriate and current corporate culture. The primarily responsibility for the corporate culture management has CEO and secondary senior management. The process of corporate culture management has four phases: assessment and diagnosis, development, implementation, and evaluation. It should hit the whole organization and be relevant to all employees.

Introduction

There were privatized almost all enterprises in the last twelve years in Slovakia. New owners want to improve the overall performance of these enterprises as well as their business results. This is especially important, because the competition increases and is expected to increase even more after Slovakia will join the European Union in May 2004. The companies hire new management teams, define new strategies and are heavily transformed. To be able to implement successfully new strategies and to transform these enterprises, it is necessary to change their corporate culture from a „socialistic-bureaucratic" type to a different one, business oriented. The corporate culture determines relations and climate in the corporation for implementation and execution of the company's strategy. The corporate culture is determined by previous development and could cause persistence and resistance to change *(Papula, 1993)*.

Bajzikova and Sajgalikova define the corporate culture as: „a set of credos, values, and norms, which are shared inside a society /company and which substantially affects the behavior of its members. This set has been built by collective experience of successful problem solving by the society during alonger time period. This set is transferred as relevant to new society members (Bajzikova, Sajgalikova, 2000)." Luptakova and Vargic define the corporate culture as: "categorizing principle of employee opinions and understanding of their work, their approach to it and the way in which they anticipate to be treated (Luptakova, Vargic, 2001)." We can say that the corporate culture is a very important dimension of the company. It affects how employees and managers access each other, problems, customers, and deal with suppliers, react to competition and how they perform various activities. The corporate culture is not completely clear and is difficult to interpret in a company. It is stable, persistent, but dynamic at the same time. It is transferred to new organizational members. The leaders of the company have very significant impact on its corporate culture.

A number of researchers, e.g. Peters and Waterman, Deal and Kennedy, who studied companies, which achieved above average results over a long period of time, showed that the most successful companies have built and managed their corporate culture. Kotter and Heskett found a strong correlation between the type of corporate culture and business results *(Kotter, Heskett, 1992)*. Corporations with performance enhancing corporate cultures grew in comparison with corporations without performance enhancing corporate cultures much faster in revenues (682% vs. 166%), employment (282% vs. 36%), stock price (901% vs. 74%), and net income (756% vs. 1%).

The process of the corporate culture management

Due to its importance, many companies are attempting to manage or change their corporate culture in recent years, but only few of them are successful. Sarkanyova did a research about organizational change in 34 companies in Slovakia. Five of the researched companies tried to change their corporate culture, but none of these changes of the corporate culture was evaluated as successful *(Sarkanyova, 2000)*. Gal and Muckova found that only 26% of 57 researched companies in Slovakia actively manage their corporate culture and they evaluate this process to be successful *(Gal, Muckova, 2003)*. The management and change of the corporate culture is quite a difficult process. It demands also changes of individuals – their personality, abilities, or skills, as well as a change in understanding of a role and position of managers within the organization *(Sulikova, 2003)*. However, it must be done, because in some cases the change of the corporate culture is a question of the company's survival. The major corporate culture change is time-consuming and very expensive. To achieve even half of the change a company attempts, it must spend an amount equivalent to between 5 and 10 percent of its annual budget for the personnel whose behavior is supposed to be changed *(Deal, Kennedy, 1988)*. The major corporate culture changes last about four to ten years; their most intensive part takes about two years.

The primary responsibility for the corporate culture management has the CEO of the company. In case, when company only starts to manage its corporate culture or needs an important change in it, the cultural manager and a steering committee focused and responsible for the corporate culture management could be established. Members of this committee should be high-level managers, key decision-makers as well as the CEO. The process of corporate culture management has four main phases: assessment and diagnosis, development of corporate culture, implementation, evaluation and control.

Assessment and diagnosis of the existing corporate culture

The first step in corporate culture management is to determine, what the current corporate culture is. This phase could be done internally by organizational members or externally by consultants or combined. The cultural assessment has several objectives:

?? To explore all aspects of organizational functioning in order to identify the values, beliefs, and assumptions currently held by organization's employees
?? To identify the personality and beliefs of the strategic leader (CEO)
?? To identify the strength and history of the existing culture
?? To identify how well the culture is understood
?? To identify major opportunities for cultural improvement
?? To identify possible barriers to cultural implementation program
?? To promote cultural awareness

The corporate culture could be analyzed by a variety of techniques, e.g. personal and confidential interviews with a cross selection of employees, group interviews, and written surveys. It is recommended to use more or all of these techniques.

Development of the new corporate culture

The next step in corporate culture management is the development of the new corporate culture. In this phase the vision, core values, and guiding principles of the organization should be prepared. A necessary input to development of these documents is the mission statement from the strategic planning effort. The mission and vision should definitely be consistent and supportive, but they will not be exactly alike, since they serve two different purposes.

A mission states what a company intends to do, to achieve, in the external environment on a one-time basis. A vision states what a company intends that its internal (cultural) environment should be or should become on a continuing basis. Because the mission is directly linked to the customers and external environment, it makes sense for the vision to be based on the mission and be developed second. The corporate culture is defined in following documents:

Vision - states, what a company intends that its internal (cultural) environment should be or should become on a continuing basis. A vision is a picture of a preferred future state, a description of what the organization would be like some years from now. The four most persuasive reasons for having a vision are: inspiration, unobtrusive control, focus, and integration.

Core Values - are the organization's essential and enduring tenets – a small set of general values, not to be compromised for financial gain or short-term expedience and not to be confused with specific practices, which are included in the guiding principles. Only a few values can be truly core – values so fundamental and deeply held that they will never change and will never be compromised.

Guiding Principles - describe how the vision and core values will be achieved. They establish the professional standards for the work done inside the organization. They specify the relationship between people in the organization – on all levels.

Before implementation, the results of cultural planning must be tested. There are more ways, how to test them, one of them are in-depth discussions in focus groups, consisting of valid cross section of the company's employees.

Implementation and shaping the corporate culture

To put the developed corporate culture into the organizational life, the implementation is needed. The behavior of CEO and senior management and the way, how they enforce the cultural values into corporate praxis is very important for the success of the implementation. The successful implementations of corporate culture have usually four common characteristics. First of all, they should be trustworthy. They should come from a credible source, like the CEO. The implementation of culture, which seems to be insincere, or which contradicts the basic organizational values would be probably rejected as company's propaganda. Second, the successful implementations of corporate culture should be dramatic. They should naturally be interesting, not boring. Third, the successful implementations should hit the whole organization and be relevant to all levels of employees. The middle-level management, supervisors and all other employees should be involved in the process of implementation. Last, the successful implementations must be easy to remember and to believe. The corporate culture should have clear relevance to the performance of all employees, e.g. it should indicate, which behavior is expected in specific situations.

The implementation of corporate culture is conducted through managerial areas. We outline few examples, how to use managerial areas to shape the corporate culture.

Shaping of subcultures might support different parts of the organization. Different subculture is suitable for research and development, which is long-term oriented, innovative, and producing ideas and in production, which is more costs and efficiency focused. The subcultures should not be too strong and act against each other, because then the individual departments do not sufficiently identify themselves with the company as whole.

The human resource management is a very important corporate culture-shaping tool. In the human resource area the important tools are: selection of new employees, socialization, development and evaluation of employees, and rewarding. In the selection process, the technical skills as well as fit of the individual with corporate culture should be taken into account on all positions, not only managerial. The corporate culture could be also shaped by development and socialization of workers. It is reasonable to invest into training activities, which learn not only the needed skills, but also imprint on employees the organizational values. Evaluation and rewarding of employees should also enforce the developed corporate culture. The evaluation criteria should be settled to identify people, who support dominant organizational values and are identified with them. This people should be rewarded and promoted.

Other often-used forms to communicate cultural values are organizational stories, myths or legends. The main actors in these stories are usually leaders, founders or key-executives of the company. These stories describe important moments from the company's history, which have implication to the current set of corporate values. Usually they are interesting and catching. Activities are also often used for shaping of the corporate culture. Activities might be annual conferences or Christmas parties, which communicate, that all employees are important for the company. Similar forms are rituals, which often imply equalization activities, like team-sport competitions.

Evaluation and control

The last phase of corporate culture management process is evaluation and control. The control should look backward, to the history; it should provide feedback to previous phases, evaluate the current situation and identify differences from expected state. This control should be also forward oriented, it should monitor the development of external and internal environment and provide signals and information for potential corrections of existing corporate culture.

The research findings

The main research objective about the corporate culture management was to outline the most important points, which successful companies in corporate culture management have in common. This research had both quantitative (sample 57 companies, structured interviews based on a questionnaire) and qualitative parts (sample 15 companies, case studies). We concentrated in this research on profit-making companies over 50 employees. The researched companies were from 15 industries. The target person in researched companies was competent employee who deals with or is eligible for qualified answers concerning the corporate culture management, mostly human resources manager or general director. The research was conducted by Peter Gal from Faculty of Management, Comenius University, Bratislava in years 2002 and 2003. Waste majority of the researched companies, which responded on the questionnaire, were interested in the research results. These are the points, which successful companies in the corporate culture management have in common:

- ?? These companies have defined their vision. This vision is positive and well communicated across the whole company.
- ?? The core values of the corporate culture have been set, e.g. good relations among employees, healthy competitiveness, mutual appreciation, cooperation, and support. Mechanisms were created so that employees would accept them. These mechanisms served for changing the attitudes and behaviors of the employees and their value orientation.
- ?? The top management was heavily involved in the management of the corporate culture. The general director and the top management dedicated a lot of time as well as needed financial resources. At the same time their own behavior affirmed the desired corporate culture.
- ?? The corporate culture was seen as a very important success factor of the company. Its influence is felt in many areas of the company, including its financial results.
- ?? The top management gained the trust of the employees, which is always difficult to obtain and is very easy to lose. Many unsuccessful managers had problems gaining that trust, but very often they were the very cause. E.g. they promised not to lay-off employees and in few months they made mass-lay offs.
- ?? The management effort was aimed at the whole company, not only on the top-level management, but also on the blue-collar level. Informal leaders were involved in this process on all levels of the organization.
- ?? Some companies changed their culture from a „socialistic-bureaucratic" type of approach to an active, creative, less centralized approach.
- ?? The attitude to change in the company was well balanced; the attention was put on the change process itself as well as the achievement of the business results.
- ?? The corporate culture management was seen as a long-term process, which entails several phases. The most intensive part would take from 2-3 years and continues though less intensively.
- ?? The companies used the results of their corporate culture evaluation as a starting point for practical implementation.
- ?? The companies paid special attention to employees. They concentrated mainly on the area of selection of employees, their socialization and continuous development. They invested alot of money on education and professional growth of employees. They tried to awaken the hidden potential in employees, energize them, and make them active.
- ?? The corporate culture management did not start with a radical change in the pay scale, however the change in pay seemed to be necessary later in the process.
- ?? The companies intensively used symbols and celebrations in the corporate culture management.
- ?? It seemed that some companies had a very healthy corporate culture despite the fact that they paid very little attention to it. This was due to the fact that the company founders established a healthy corporate culture at the beginning and it was maintained by company policies, e.g. selection process and socialization.

Conclusion

Many enterprises in Slovakia are in a process of transformation. It seems that the change of their corporate culture is one of the key elements in their transformation. In this article about the management of the corporate culture are compared the theoretical basis from the foreign literature with the practical experiences of companies in Slovakia. The research results deepen the theoretical basis and make them applicable for more efficient corporate culture management. The most important issues from this article are outlined in the corporate culture management model (Fig.1).

Why to manage the corporate culture?

To solve problems or difficulties in the company.

Corporate culture is a very important success factor of the company.

Corporate culture influences „soft“ - atmosphere, relations, ethics as well as „hard“ areas - innovations productivity, financial performance, and costs.

Who should manage the corporate culture?

The general manager.

Top and senior level managers.

Informal leaders on all levels of the organization.

The corporate culture management should hit the whole organization and be relevant to all employees.

Healthy corporate culture

Strategically appropriate corporate culture which enhances the company’s performance.

When to deal with the corporate culture?

When there is a difference between strategically appropriate and current corporate culture.

The business environment changes significantly.

The company is in the process of strategic change or wants to solve important organizational problem.

In case of merger, acquisition, creation of joint-venture or any other form of partnership.

How to manage the corporate culture?

Asses and diagnose the existing corporate culture.

Develop the new corporate culture based on strategy – vision, core values and guiding principles.

Implement the corporate culture. Use management tools – shape the subcultures, use human resource management, communicate, ... and be persistent.

Evaluate, control, and celebrate.

FIG.1 THE CORPORATE CULTURE MANAGEMENT MODEL

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Managers in Culturally Diverse Environment

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Abstract

Formation of Multinational Corporations bring a formation of an international working environment, requiring quality changes not only for top managers, but also for all employees of the organization. This situation requires new abilities in many previously neglected areas. Success of organizations will be determined by managerial qualities such as cultural sensitivity, flexibility, justice, alertness, ability to cope with stress situations, ability to solve interpersonal problems and conflicts, strive for continual self-development and life-long learning. Ability to understand a multicultural environment is a condition of benefit from this situation, and can lead to higher performance, greater creativity and synergy effects among the employees. Success of organizations will also depend on the managerial ability to lead multicultural teams - people from different cultural background, and on the ability to see that culturally diverse environment brings not only advantages and opportunities but also certain problems. If the organization is to effective manage the impact of cultural diversity, it must not ignore it, but use and understand it and learn that people may have different perceptions of reality, different thinking and problem solving, different values, attitudes or styles of communication. Low level of knowledge about cultural determination of human behavior may lead to interpersonal conflicts, negative relations and a working atmosphere that negatively influences individual and team productivity and inhibits an effective style of leadership.

Introduction

At present, with globalization eliminating differences between national and international corporations, the significance of international trade is growing and multinational companies are being established in Slovakia. Their structure and strategy, but also philosophy, culture and management are acquiring new qualities. With the establishment of international companies comes the formation of an international work environment requiring changes in quality not only of top managers, but all other employees as well. Skills of available human resources determine whether organizations succeed; indeed, skilled employees become their employer's competitive advantage. Knowledge, skills, abilities and personal qualities of managers will differentiate organizations form one another and will become the key and the condition of their excellence. Managerial qualities such as emotional ability, cultural sensitivity, flexibility, justness, readiness, ability to control stress situations, interpersonal ability as well as the ability to continually learn and develop will become an integral part of the success of organizations, and managers themselves. Acceptance and effective use of the potential and heterogeneousness of their employees condition the success of organizations with multicultural environment. The ability to understand the asset of a diversified environment is the condition for profiting form diversification, which can lead to better performance in areas of creativity and knowledge and to synergic effects in the workplace, where people will respect each other and their differences. Differing point of view or opinion will be appreciated; skills and abilities of others will not only be shared, but also supported. Success of organizations will depend on the ability to maximize the potential and capabilities not only of individuals, but foremost of teams consisting of these individuals. Success will depend on the ability to find managers with new abilities, capable of effectively leading multicultural teams and people with different cultural background, with different standards of behavior, values and ways of communicating.

The important attributes for interaction of people in multicultural environment will therefore become:

??Recognition of the others' competencies (areas of expertise)
??Mutual acceptance - respect for standards, opinions and approaches of others
??Respect for the autonomy of others
??Development of creativity
??Support of positive interpersonal relationships

??Acceptance of diversity

??Use and development of personal potential equally in all

??Desire for self-development, self-improvement and life-long learning

??Ability to find, use and develop strengths of individuals and teams etc.

The leading philosophy for multicultural environment organizations will be the one that appreciates diversity, respects varying needs and requirements, and demands creativity and new ideas. Under this philosophy managers understand that leading people means leading the teams and individuals at the same time, self-management is emphasized and it is evident that there is no one and only correct and efficient style of leading for all and in all circumstances. The task for managers of successful international organizations will be to join people from different cultures to attain the aims of the organization.

Although the process of globalization brings varying cultures closer and closer, increases the contact of people of differing backgrounds and opens new possibilities, it does not mean that the cultural differences will disappear. It means that the need for understanding cultural differences (approaches, standards, behavior, problem solving) increases. Likewise, higher flexibility, open-mindedness for new ideas, opinions, demands and higher sensitivity for others, as well as a differentiated approach to and leadership of other people are needed more than ever before.

A successful manager in a multicultural environment should have knowledge about cultural differences and similarities of various cultures, and should have special abilities for effective interpersonal interactions. Knowledge of cultural differences is important primarily in regard to the approach to human resources. Managers should be able to work with human resources effectively irrespective of their origins, and should be able to choose the right "custom-tailored" approach. The ability to manage the intercultural interactions of individuals or multicultural teams is become essential.

It is important to emphasize that not only top managers participate in the interactions, but also lower level managers and common employees are included in the multicultural environment. Therefore it is necessary to develop and require the desired abilities in all employees of the organization. Development of these abilities in such multicultural spirit should become the challenge and the philosophy of the organization.

Influence of Culture on Management

The notion of culture may be understood as a set of opinion and attitudes about what is adequate and what not a given environment is. It is a set of values that is formally or informally endorsed; it is a way of thinking that differentiates one group of people from another. Cultural differences lead to differences in the perception of things and events, their interpretation, differing ideas on how to handle them, differences in value systems, in approaches to problem evaluation and solving, and in the way of communicating one's feelings, opinions and ideas in relation to superiors, subordinates or to the external environment.

Differing as well are standards of behavior, preferences and the aspirations of people with different cultural background - people who are part of the multicultural environment of the international organizations. Knowledge and understanding of cultural differences is becoming an essential requirement for effective multicultural manager competency, and a requirement for creating new development programs for managers (Sajgalikova & Bajzikova, 2000).

On the other hand, lack of understanding and knowledge of the influence of culture on the behavior not only leads to conflicts, to a deterioration of interpersonal relations, to a bad work environment and to a decrease of the productivity of individuals as well as teams, but it also hinders the managers in their effective leadership and motivation and their problem and conflict solving. Such conditions lead to a decrease the competitiveness of the organization.

The necessary condition for managers to become effective intercultural managers is a change of their thinking, changes of certain aspects of their personality-changes in their approach to people, changes in the forms of behavior, a need for a higher level of cultural sensitivity, greater openness to others and so on. In accordance with previous research the factors which most strongly determine an individual's behavior and which managers should respect are:

??Attitude towards uncertainty - the extent to which people from different culture prefer more or less structured tasks and situations, the extent to which they prefer rules of problem solving, the extent to which people try to avoid ambiguous situations

??Acceptance of an unequal distribution of power - people from different cultures differ in the extent they accept power, authority, status, and in their effort to participate in the decision-making process

??Collectivism vs. individualism - the extent of an individual's integration into the group and social environment, identification with their goals and interests, the level of support of the principle of equality, the emphasis on future or present. Individuals from collectivistic cultures prefer common goals and objectives, cooperation, collective decision-making and reward. On the other hand, people from individualistic cultures follow individual goals and interests, they emphasize skills and knowledge heterogeneity, independence, individual responsibility and reward; they prefer short-term goals and immediate effect and satisfaction of their needs.

??Gender Differentiation - cultures differ in the emphasis they place on different roles of men and women. Some cultures (Germany, Denmark) offer equal possibilities for both genders in education and professional careers. Conversely, there are cultures where no such possibilities exist.

??Time orientation - it is reflected in behavior and problem solving in the present. Time orientation can be focused on the past, present or future. This orientation influences all managerial activities, ways of planning, decision making, profit reinvesting, remunerating. Other examples of different perceptions of time are creating a strong barrier between private and office time, understanding of the notion of punctuality, or devoting time to business and managerial activities.

??Perception of the human nature - the extent to which there is a tendency, caused by various cultural influences, to see a human being as substantially good or bad. These cultural influences determine the behavior of individuals, including such managerial activities as the leadership style, the systems of control, remuneration etc.

??Performance focus – reflects in the way of compensation, in the professional development, acceptation and support of the excellence of individual

??Humanity – level of social support and award for individuals who are fair, true, friendly and tolerant. On the other side are cultures support power, materialism, and problem solving by individuals themselves

??Usage of space – strong feeling of the private space ownership, differences in the positioning of the barriers to the space between managers and subordinates, differences in the rooms equipment.

Effective manager in multicultural environment should know and understand the above-mentioned differences and the others as well. This knowledge is the condition of the correct people approach, choosing the adequate leading style, motivation, decision-making and evaluation and also the selection developing programs for personal development of manger and his subordinates as well.

Interpersonal communication is the part of the interpersonal interactions. Managers in multicultural organizations should have high quality communication skills in all fields, especially in the leadership. Effective interpersonal communication requires the knowledge about partner’s cultural individuality. Ability to provide the feedback, to work with information, solving conflicts is necessary to adjust to different cultural customs, opinions and values.

Effective communication in Slovak business environment is possible to characterize as open, direct, supporting the feedback (Luptáková – Vargic, 2001). On the other hand communication style in many Arab countries should take in to consideration the status, gender and age of partners in communication. Free-spokenness and directness is not acceptable.

In some cultures the preferred communication style with subordinates is one-way. Elsewhere this communication style is considered to be ineffective and discussion is preferred and emphasized.

Approaches to leadership are different depending on the cultural uniqueness. Manager should perform authority when he could not expect subordinates to participate in responsibility or decision making or otherwise, he should apply participative leadership style or combination of these styles in accordance with the situation and personalities in team. It is important, when working with people, to take in to consideration the cultural differences. IT cannot be expected the same style and approach to be effective in every situation, every culture or conditions.

Multicultural Teams

Success of organizations depends on individuals, as well as teams and effectiveness of team work. To be an effective manager of a team requires specific features of the manger's character and his interpersonal skills. It is even more difficult to work with a multicultural team. There is not only heterogeneity of gender, age and education but also the influence of each individual's culture. Cultural diversity often causes conflicts, tensions in interpersonal relationships, misunderstanding of received information, ineffective problem solving. Only manager willing to acquire intercultural competencies and skills and to apply them can become a successful intercultural manager.

Intercultural teams, like many researches have proved, are in general benefit for the organization for the very existence of different believes, attitudes and ways of thinking.

TAB 1: .SOME POSITIVE AND NEGATIVE FEATURES OF MULTICULTURAL TEAMS

Positive features	Negative features
New ideas, opinions, points of view	Increasing of uncertainty
Space for learning	Increasing of conflicts
Productivity support	Troubles in interpersonal communication
Creativity support	Ethnocentrism
Instigation to staring ambition	Increasing of tension and stress
Instigation to flexibility	Initial decreasing of productivity
Increasing of employees sensitivity	Initial problems in leading people
Increasing of relative understanding	Initial problems with motivation of employees
Increasing of toleration	Bilateral misunderstanding

Personal Qualities of Mangers in Multicultural Environment

In the research of top managers in 180 successful international organizations managers indicate as significant personal characteristics most needed for their job as follows (Abbas – Camp, 1996, p. 4):

?? Ability to get on well with people from different culture with different hierarchy of values
?? Flexibility of attitudes
?? Accepting changes and adaptability
?? Ability of global perspective
?? Cultural, political, economic knowledge of different culture
?? Communication skills
?? Cultural empathy and sensitivity

Managers in multicultural environment should have competencies that could be divided into three categories: (Black, J. S. & Mendenhall, M., 1990)

1. Self maintenance – ability to control stress and barriers and on the other hand willingness acquire the cultural knowledge about strange courtiers, that help to understand people's behavior and thinking,
2. Interpersonal competencies – ability to create and maintain positive interpersonal relationships among people from different cultures
3. Perception competencies – ability to apperceive and to interpret behavior, to tolerate ambivalence

There is higher possibility of existence of the different assumptions and expectations, different perception of phenomenon and things and their meanings in the frame of intercultural interactions. Nonverbal exhibition, which accompanies the interpersonal communication, could be also interpreted differently and inadequate.

Comparison of the manager features in traditional organizations and in successful organization with multicultural environment is in the Tab. 2.

TAB. 2: COMPARISON OF THE MANAGER FEATURES IN TRADITIONAL ORGANIZATIONS AND IN SUCCESSFUL ORGANIZATION WITH MULTICULTURAL ENVIRONMENT:

Traditional manager features	Required manager features in multicultural environment
Hard skills preferring	Soft skills and hard skills preferring
Self vision	Support for the vision of the others
Individualism, egocentrism	Orientation to the others
Personal development of individuals	Personal development of subordinates
Higher status position	Team unity
Usage of power and control	Participative leading
Individual concern	Team and organization concern
Focus on present and past	Focus on present and future
Fixed value order	Differences and paradoxes acceptation
Monoculture communication	Intercultural communication skills
One-way communication	Multi-ways communication
Frequent emphasizing of individual weaknesses	Focus on individual strengths and their development
Close confidence understanding	Complex approach to the confidence

Change manager to effective manager in multicultural environment requires changes in his personality in the level of his knowledge, skills and abilities.

It is difficult, long-term process and change could not be reached within a day. Required changes are reachable trough adequate chosen training programs and effort of managers themselves. The imaginations that the opinions from the visit of strange culture are sufficient for understanding and leading strange culture people, the idea that one training is guarantee of manager's ability is wrong as well as the imagination, that only one problem solution is correct and the only opinion is correct. Developed countries of Western Europe and USA pay attention to development and the quality of human resources. Human resources are key factor of organization achievement and become their competitive advantage. It is very important for Slovak organization to pay attention to these significant aspects. The subject of other research is the investigation what abilities of managers are supported in Slovak organizations, what abilities do managers really have, in what extent, what competencies do managers develop to meet the difficult requirements for international managers.

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Safety Culture and OSH Performance: An Exploratory Study on SMEs in Malaysia

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Abstract

This study sought to explore the relationship between occupational safety and health (OSH) performance and safety culture in small and medium sized enterprise (SMEs) in Malaysia. A total of 118 manufacturing SMEs representing electrical machinery, apparatus, appliance and supplies; furniture and fixtures (wood-base); and food and drinks industries attended the postal survey. Regression analysis reveals that the model was significant and it explained 70.7% of variance in OSH performance.

Introduction

Industries worldwide are showing increased interest in the concept of "safety culture" as a means of reducing the potential of large-scale disasters, as well as the inherent risks associated with routine tasks [5]. Its growing importance can be seen from its application, for instance, offshore [14], nuclear [21] and shipping [12]. However, the wave of interest has over sighted the plights of small and medium sized enterprises in managing occupational safety and health issues at workplace. Studies have found that the working conditions were unattended, long working hours, higher work-related accidents and higher health injuries due to chemical, ergonomics and mineral dusts are among the known common characteristics of small and medium enterprises [8]; [13]; [19]. It was also revealed that workers in SMEs are generally unaware of hazards they are exposed to, legal requirements on OSH are often not complied with, and preventive measures are seldom taken by SMEs [12].

Even though safety culture has received much attention, yet literature offers no consensus on the operational definition of safety culture. Nonetheless, studies of the literature reveal two sets of definition: safety culture as a "product" and as a "purpose" [5]. As a product, safety culture is viewed as an emergent property of social grouping such as, set of values, beliefs and attitudes reflecting an "interpretative view". On the other hand, safety culture as a purpose reflects that culture has a predetermined function such as, implementing controls and policies to improve safety performance. Examples of the former definition may be viewed in Tumer, et al. [24], The International Atomic Energy Authority (INSAG) [9], and The Confederation of British Industry (CBI) [4]. The later definition may be seen in the U. K. Health and Safety Commission (HSC) [7].

Safety Culture and OSH Performance

The term "safety culture" was first introduced in 1987 in Organisation of Economic Cooperation and Development (OECD) Nuclear Agency report on the Chernobyl disaster in 1986 [10]. The concept of safety culture was loosely used during that initial stage to describe the corporate atmosphere or culture in which safety is understood to be, and is accepted as, top priority [6]. Such understanding was partly due to fact that safety was not treated as the dominant characteristic of an organisation's culture. As such, safety culture is treated as a subcomponent of corporate culture, which alludes to individual, job and organisational features that effect and influence safety and health. Nonetheless, the organisational dominant component of corporate culture, such as downsizing or restructuring will influence the development of subcomponent for instance, safety culture [18]. Consequently, safety culture also affects other operational processes or organisational systems [5]. Thus, safety culture does not operate in a vacuum, it interrelate with other processes and systems and reinforce each other within the organisation.

In practice, safety culture is developed through deliberate manipulation of various organisational characteristics that is perceived to increase safety performance, for example, conducting risk assessments [5]. Such an act of manipulating is intentional to achieve the desired goal or a specific purpose such as: to increase people's commitment to safety; to determine the style and proficiency of a safety programme [7]; to ensure that safety issues receive appropriate attention [9]; to ensure that organisational members share the same idea and beliefs about risk, accidents, and ill health [4]; and to reduce accidents and injuries [24]. Each of these purposes, as argued by Cooper [5] has two complementary roles: it may served as a sub goal that helps an organisation to attain its super ordinate goal, such as developing a safety culture; and it may also served as a goal that is, the consequence achievement that arises from the action of safety culture. Therefore, developing a safety culture may be achieved through sub goals such as, providing safety training, conducting risk assessment or auditing safety systems that will direct people's thought and behaviour to the management of safety, and through safety performance.

The confusion that surrounds safety culture in relation to safety and health performance lies in the lack of clarity about the "product" [5]. This is because safety culture "product" is viewed as a consequence that provides measurement of an outcome. This approach to safety performance is based on recorded statistics such as, accidents rates or lost-time index for incidents that has already happened. These performance indicators are frequently termed as reactive indicators [3]; [22] due to their post-effect nature. As such, many are sceptical about its effectiveness as safety performance indicator. For instance, O'Brien [16] argues that they do not accurately reflect a company's safety performance and therefore misleading. In this respect, the reduction in accident and injury rates, although an important indicator, are not sufficient in themselves to indicate the presence or quality of a safety culture [5]. However, this limitation on safety culture may be offset from the perspective of "purpose", that is safety culture as predetermined functions with regards to safety performance for instance, to determine people's commitment to safety, and the style and proficiency of safety programmes. This approach to safety performance is based on proactive indicators that are associated with organisational processes, systems and individual behaviours [23]; [11].

Employing multiattribute analyses, Molenaar et al. [15] classify safety culture into three main dimensions: people, process and values. The first dimension – people, is integral to define the cultural characteristics of an organisation. It is the people who determine the beliefs, values and behaviours that create an organisation's culture. The second dimension – process, is the manner in which an organization incorporates safety and health into practices. The third dimension – values, is concerns with organisation's philosophies regarding OSH. It determines the extent to which employees' belief that safety is a high priority of the organisation. The characteristics of the above dimensions are discussed as follows.

Methodology

The definitions of "small" and "medium" sized enterprises differ from one country to another. SMEs have been defined against various criteria such as the number of workers employed, the volume of output or sales, the value of asserts employed, and the use of energy [25]. For example, Rinefort [20] categorised small and medium firm by the number of employees. A firm is categorised as small if it has fewer than 50 employees, and a medium firm if it has between 50 to 199 employees. Aziz et al. [1] categorised a company with an annual sales turnover of not exceeding RM25 million and full-time employees of not exceeding 150 as SME. While OECD defines establishment with up to 19 employees as "very small"; with up to 99 as "small"; and from 100 to 499 as "medium"; and over 500 as "large" [25]. For this research purpose, a firm employing between 40 to 499 full-time employees is defined as a SME. The minimum number of 40 full-time employees is taken because the Act 514 mandates a workplace with minimum 40 employees to form a safety and health committee. This decision is in line with this study since a firm with 40 employees and more is legally required to manage safety and health at workplace. Therefore, an enterprise with 40 to 99 full-time employees is categorised as a small sized firm, while an enterprise having between 100 to 499 full-time employees is categorised as a medium sized firm.

It was a postal survey using a set of 60-items questionnaire to collect cross sectional research data on small and medium enterprises in three areas of manufacturing: manufacture of electrical machinery, apparatus, appliance and supplies; manufacture of furniture and fixtures (wood base); and food manufacturing and soft drinks and carbonated water industries in Peninsular Malaysia.

The population of this study covered all SMEs manufacturing electrical machinery, apparatus, appliance and supplies; furniture and fixt ures (wood base); and food and soft drinks and carbonated water registered with the Social Security Organisation (SOCSO).

The respondent was a full-time employee of the enterprise who is responsible for the occupational safety and health with at least one-year involvement in safety and health.

A total of 452 samples from a population 1129 were selected for data collection. The distribution of samples is shown in Table 3.1. A total of 198 questionnaires were returned; 118 questionnaires were attended and 80 were unattended. The response rate was 31.72%.

TABLE 3.1 DISTRIBUTIONS OF SAMPLES AND INDUSTRIES

Industries	Small (%)	Medium (%)	Total (%)
Electrical machinery, apparatus, appliance and supplies	131 (49.0)	120 (64.9)	251 (55.5)
Furniture and fixtures	95 (35.6)	40 (21.6)	135 (29.9)
Food and drinks	41 (15.4)	25 (13.5)	66 (14.6)
Total	267 (100)	185 (100)	452 (100)

The research instrument was adopted with modification from Molenaar et al. [15] who studied safety culture in construction industry and from Burke et al. [2] who studied safety performance. However, in order to suite with the Malaysian environment, legislation and the purpose of the research study, the instrument underwent minor modification. Since it has undergone minor modifications, pre-test of the instrument were done to ensure its validity and reliability.

The pre-test results showed that the Cronbach's alpha reliability coefficient scores were in the range of 0.7581 to 0.9154.

Findings and Discussion

Regression analysis indicated that 70.7% of variance in OSH performance was explained by the independent variables – people, process, and value (F = 91.704: Sig. = .000).

Correlation results show significant association between OSH performance and each of the independent variables (Table 4.1). The results provide evidence that OSH performance is significantly related to safety culture.

TABLE 4.1 PEARSON CORRELATION MATRICES

	OSH Performance	People	Process	Value
OSH Performance	1.000	.723*	.714*	.805*
People		1.000	.735*	.772*
Process			1.000	.670*
Value				1.000

*P< 01.

The standardized coefficients of each independent variable indicate that the relationship of variables - value and process on OSH performance were significant but the relationship of variable - people was not significant (Table 4.2).

TABLE 4.2 STANDARDIZED COEFFICIENTS

Model	Standardized Coefficients	t	Sig.
	Beta		
(Constant)		3.175	.002
People	.103	1.142	.256
Process	.276	3.583	.001
Value	.541	6.589	.000

The study highlights some insights with regards to the relationship between OSH performance in SMEs and safety culture. Nevertheless, the finding has to be treated with care since the response rate was rather low. Further investigation is highly recommended.

Conclusion

The study reveals that safety culture structure is a relevant approach to manage OSH performance in SMEs in manufacturing sector. The study focuses on three major components of safety culture. Two components i.e. value and process were significant. However, the people component was rather weak. This finding supports the general feeling that commitments from the management of SMEs were lacking and poor involvement of the managers in OSH activities at workplace.

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Sustainable People

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Abstract

This paper suggests that the concept of sustainable development has considerable limitations because it has become abstract and too often ignores that many forms of development (oil and gas exploitation, mining) are not sustainable. Development, as the well-worn cliché puts it, is about people. Our approach at the Community Development Institute focuses on how individuals can become sustainable and motivated to develop their own potential while at the same time working towards the development of their organizations and communities. Discussions about development thus move from abstractions to ways in which specific individuals can live good lives (as they define them) while contributing to their communities. The concept of sustainable people is linked to that of community development, which offers a middle way for the creation of employment and wealth between the efforts of the state and those of the private sector, especially in poor and marginalized areas.

Sustainable People

Each year, statesmen, politicians, financiers, business corporations, executives and other rich and powerful people meet at the World Economic Summit in Davos, Switzerland to discuss the state of the world. In recent years, the World Social Forum in Porto Alegre, Brazil, has brought together activists, grassroots leaders, clergy, radical young people, anarchists and others united by a dislike for capitalism. They lament its ills and discuss alternatives to the market economy. The two very different gatherings reflect ongoing tensions in local, national and international development. Capitalism, rooted in competitive individualism, concerns the creation of wealth and the production of goods and services. Proponents of the Social Economy promote the redistribution of wealth and focus on quality of life issues such as pollution, sweatshop conditions, etc. They tend to favour collective action through community consensus, and many protest at international business gatherings.

Most of the protesters come from the middle class; poor people do not have the time or the resources to travel abroad to confront people. A major challenge to governments and leaders in the private sector lies in determining ways in which the genuine idealism, enthusiasm and energy of discontented western youth can be channeled into socially useful outlets. An even bigger challenge involves determining ways to create jobs for millions of young people in the developing world who live in idleness or join fundamentalist groups.

Some young people in the industrialized and developing world are attracted by the concept of sustainable development. Many forms of development such as oil and gas exploitation and mining of ores are not sustainable. The communities based in them vanish or decline once the resource is depleted. Canada, like other primary producing nations with boom and bust economies, has scores of ghost towns that once were the scene of frantic activity. Sustainability remains a sensible notion that can direct the conservation of renewable resources and avoid the "clean up and clear out" ethic that has damaged so many parts of the world.

The concept of "sustainable people" focuses on real people living in communities, rather than on abstract ideas about protecting the common good [1]. Sustainable people, human, fallible, contradictory, are much more difficult to create and encourage than vague academic and intellectual concepts that tend to be endlessly defined and redefined. Increasingly, people want to have some control over their destinies, but find it difficult to do so in a world dominated by large corporations and state bureaucracies. Through establishing their own business ventures, poor people and others can put their feet on ladders leading to better lives for themselves, their families and their communities.

As the last century ended, communism collapsed and scandal engulfed large business corporations. A healthy mistrust of state control of the economy and capitalism became pervasive, as interest rose in ethics and the moral basis of society. Václac Havel, a dissident writer who became president of the Czech Republic in 1989, noted:

"A modern state cannot consist merely of civil service, political parties, and private enterprise. It must offer citizens a colorful array of ways to become involved, both privately and publicly, and must develop very different types of civic coexistence, solidarity and participation" [2].

As the gap between governments and their citizens has widened, the concept of civil society has become increasingly popular. An American scholar defined it as; " [T]he realm of organized social life that is voluntary, self-generating, (largely) self-supporting, autonomous from the state, and bound by a legal order or a set of shared rules[3] ."

Social change creates new kinds of organizations and roles as the existing ones prove unable to cope with new demands. With the real and perceived failure of states and the private sector to generate jobs and wealth among poor and marginalized peoples, new forms of business organizations have emerged through which these people become participants in their own personal development and that of their communities.

In the 1920s, the British government made vast plans to improve the lives of their colonial peoples. When the Great Depression hit in the 1930s, it ran out of money to implement them. District officers combined government resources with those of the local people, including labour and land on community self-help schemes [4]. Thus began the community development movement. In Canada, Father Moses Michael Coady launched the Antigonish Movement during the darkest days of the depression. Based at St. Francis Xavier University in Antigonish, Nova Scotia, the priest gathered around him a group of dedicated clergy and lay people who went into small communities to encourage people to: "Listen. Study. Discuss. Act." Poor fishermen and farmers pooled their nickels and dimes to establish credit unions and co-operatives. In 1939, Coady published a book whose title summarized his goal of making poor people Masters of Their Own Destiny [5]. From humble beginnings, the credit union and co-operative movements have become big business in Canada. In 2000, credit unions had $122 billion in assets. Co-ops had 4.8 billion members, $30.2 billion in revenues and $17.4 billion in assets.

In the 1960s, the American and Canadian governments declared war on poverty. Prime Minister Lester Pearson of Canada announced:

"As a philosophy and a method, community development offers a way of involving people more fully in the life of their communities. It generates scope and initiative which enables people to participate creatively in the economic, social and cultural life of the nation" [6].

Community development soon became the flavour of the time.

Welfare and charitable agencies described their traditional activities as a form of it. Young people, including members of the Company of Young Canadians, a government funded agency, saw community development as a way of confronting – and perhaps overturning – the establishment [7]. The study of poor people and marginalized communities became an academic growth industry. Increasingly those outside the mainstream of society tired of outside experts coming in to their communities, telling them that they had problems, and launching government-funded interventions without an understanding of the dynamics of local life. In 1967, leaders in the Bedford-Stuyvesant area of New York invited Senator Booby Kennedy to visit their community. Concluding that official, top down, anti-poverty programmes were not working, he and Senator Jacob Javitz sponsored the Special Impact Program to tap federal funds for bottom up efforts in local development. They also brought together black leaders from the area with white business people from outside its boundaries to set up the Bed-Stuy Restoration Corporation [8].

Thus began the modern era of community economic development.

The principles underlying it – self-help, mutual aid and collective action – are as old as homo sapiens. By the late 1960s, CED as it became known, was firmly established in the United States. Poor communities set up their own business organizations to meet local needs, create employment, train people, generate and distribute wealth. With federal government funding, block associations, church, unions and ethnic groups became leaders in this new field of local economic development. In 1982, The Regan administration cut back federal funds for CED. The Bed-Stuy Restoration Corporation laid off half of its staff and sold some of its land. CED ventures had to deal with internal community tensions as well as external forces. When riots exploded in Los Angeles after the Rodney King decision in April 1992, the Watts supermarket, owned by a CED corporation, went up in flames. Other community business ventures collapsed through mismanagement and corruption.

But much has been learned about the most effective way to set up and run CED ventures and about the kinds of people who emerge as leaders in this complex field.

In 1976, a group of Cape Bretoners incorporated New Dawn, the first community development corporation in Canada. This venture originated with the passion and vision of Father Greg MacLeod, a charismatic priest inspired by the Mondragon enterprise in Spain. This arose under the direction of a priest who encouraged a small group of engineers in a Basque country to launch a locally-controlled enterprise. Mondragon has become a major player in Europe and the labour force no longer has same input into the decision-making processes as once they did [9].

New Dawn arose from the frustrations of local residents. The federal and provincial governments nationalized the coal and steel industries and poured millions of dollars into them in a vain effort to make them profitable. They also launched megaprojects, including two heavy water plants that closed after they failed to find a market for their product. The governments also tried to lure entrepreneurs to the island to start businesses. Some took the grants, opened factories, then closed them and decamped to places with lower labour costs.

Einstein defined insanity as doing the same thing again and again and expecting different results.

New Dawn struggled with little money and lots of volunteer help, raising capital locally and tapping into any government programme that met the needs of those they set out to service. The venture offered a new model for regional development, rooted in concern for creating new businesses that met social needs and reinforced the sense of local identity.

The corporation almost went bankrupt several times. It built much needed affordable houses and community services, and took over an abandoned radar base, turning it into senior residences with a built-in system of care givers. New Dawn assisted two laid-off welding instructors to set up a school which became immediately successful.

New Dawn did not avoid problems common to other businesses. Misreading the market, it launched a reusable diaper venture that lost $150,000. And it devoted resources to Telidon, a government sponsored videotext system for which no market existed.

In 1990, the Economic Council of Canada issued a report, <u>From the Bottom Up: The Community-Economic Development Approach</u>. It concluded that "Top down bureaucracy-driven plans for regional development have fallen into disrepute and policy makers know they need to consider new approaches [10]." A series of studies commissioned by the council described some of the successful CED ventures, ranging from a credit union launched by a community in Labrador when a bank left town to the Kitsaki Development Corporation in Saskatchewan, an Indian enterprise, that flourished with the help of an American visitor who set up joint ventures with non-Indians.

The 1990s saw wild enthusiasm in Canada for CED while the problems of setting up and running them were worked out in practice. The New Democratic Party that took power in Ontario at the beginning of the decade set up an agency to encourage CED. Officials from it descended on West End Community Ventures in Ottawa, a small, struggling enabling agency in the multi-ethnic area and offered the members a large grant. It came with targets for the number of jobs to be created by the venture. Despite their best efforts, the management could not meet the targets in the time laid down by the government agency and lost the funding.

While recognizing the value of CED as a way of meeting economic and social needs, governments in Canada and elsewhere still remain suspicious of this approach to local development. And too much government money can be the kiss of death for CED enterprises if it does not come at the right time and in the right amounts. The experiences of local business initiatives on Prince Edward Island offer ways of understanding how community ventures and economic democracy can succeed or fail. The Island grows huge quantities of potatoes, so a chip plant appeared to be a logical economic opportunity. The Acadians in this province, like the Basques in Spain, have a strong sense of collective identity. In 1986, a potato chip factory was launched as a worker's co-operative. Thirteen members invested $5,400 each, the local credit union put in $101,000 and federal and provincial grants contributed $374,000. The plant proved too small to compete with major producers and went into receivership in 1992. The workers and other investors lost their equity, but the new owner, a private businessman, retained the work force and upgraded the plant.

Other collective ventures, especially funeral co-operatives, have proved successful. Whatever the rhetoric about the free market, business people do not believe in competition – except among the suppliers. The funeral co-op movement on the Island began when Father Eliot Aresenault returned home in the mid 1980s. He discovered that poor parishioners spent up to $5,000 on funerals. He found a carpenter to make coffins, a licensed embalmer (as required by provincial law) and a group of volunteers to run the co-op. The funeral business on the Island is dominated by large corporations. Funeral directors pressured the bishop to transfer the priest from the Island, and refused to let the co-op join the association. They demanded that a Québec cabinet-maker stop supplying caskets to the co-op. This boycott ended when sympathetic co-ops in the province threatened a boycott of their own against the casket maker. The funeral directors filed criminal charges against the first graduate of the co-op's embalming course for not being properly licensed. A judge dismissed the charges.

Funeral co-ops have spread on the Island and in Atlantic Canada. They have a vital social component – they return the ceremonies associated with death to the local community instead of having them removed to larger centers where corporate funeral homes are located. One key factor in the success of CED in Prince Edward Island is the presence of a champion in the provincial government who keeps his fellow civil servants and politicians informed of what this method of generating employment and income involves [11].

CED ventures come in diverse forms. They include enterprises and venture centers, CED corporations, small business development agencies, regional development agencies, worker-co-ops, worker-owner businesses, community supported agriculture, community gardens, etc. They are countervailing forces of globalization, seeking to blend social and economic aims in ways that give communities and their residents more control over their destinies.

The new forms of business come in two basic forms: community ventures owned by community residents (CD Corporations, worker co-ops, etc.) and facilitating, enabling, non-government agencies that seek to help people, individually and collectively, to help themselves. They seek to do the following:

Provide ways whereby people can make better decisions. This involves more than simply handing out pamphlets. It requires an understanding of the choices and options available to individuals in communities and how they see them. All communities have a wide range of resources that can be tapped for personal and community development. Enabling agencies know where they are in terms and conditions of access to them.

Show people how to be more resourceful. HRDC in Halifax, Nova Scotia, has moved a thousand people from the welfare rolls into employment in small businesses. One of these complained that his wages were too small. It was pointed out that he was earning the same as many others in the enterprise and should tailor his lifestyle to his income. People seeking affordable housing through a community corporation in Winnipeg are told that they cannot have a house unless they have an income. This shifts their attention from house seeking to job seeking. In Cape Breton, a labourers' co-operative venture developed a scheme through which unemployed members could buy their houses. Working union members paid part of their hourly wage into a fund, and lowered the cost of their labour when building houses for fellow members.

Indicate how people can organize and motivate themselves. The emphasis in community-based development is on putting the onus on individuals and groups for taking control of their destinies. This is the key to creating sustainable people, individuals who can see themselves as actors in their own lives, not victims of the actions of others or bystanders in the great drama of life. While messianic visionaries are vital at the beginning of community development ventures, they are seldom good managers. Over reliance on one individual and his or her ideology has proved fatal to many collective ventures.

The successful CDCs resemble virtual corporations [12]. Such ventures are set up to undertake specific tasks within specific periods of time. They have a flat organizational structure. In the early days of community development, new initiatives sometimes collapsed in anarchy as everyone tried to do his or her thing for the benefit of the collective good. Or they became highly structured, rigid, inflexible, routinizing their operations, becoming remote and inaccessible to those they set out to serve.

Collective ventures resemble wheels, not pyramids. They are knowledge and information driven. In pyramids of power, information moves up and down the layers, being interpreted and reinterpreted at every level in ways that meet the needs there. Those at the tops of the pyramids seldom know what is happening at the lowest levels – and outside the organization. In the wheel model, information circulates all the time. The hub, the spokes and the rim are equally vital to the running of the operation and are interdependent. Everyone is in contact with the road – the real world over which the wheel travels.

The way in which successful small businesses operate offers guidance to community ventures. Like them, they require someone who scans and screens inside and outside the community for new opportunities. Small businesses need to find new products and new services to sustain themselves – and new markets. This requires the capacity to scan and screen society to find out where these are. In the same way, community ventures have to find market niches for their products and services. New Dawn initially focused on providing housing, later moving into other fields. HRDA, a government-funded agency set out to create small businesses for welfare recipients that did not compete with those operating in the city. Window cleaning created opportunities for people with few skills to earn a living. The corporation also acquired the local Rent-a-Wreck franchise. It proved profitable but did not generate jobs for unemployed people and was sold. Community development ventures have to be aware of the tensions and pressures in communities so as to tackle problems before they become crises.

George Foster identified one of the factors that makes community development difficult in some peasant societies. He coined the phrase "Limited Good" to describe how poor people see their local economies. If someone appears to be receiving more than their "fair share" of resources, they are judged to be stealing from others [13]. Edward Banfield lived in rural Italy in the 1950s and noted the presence of "amoral familism" which led to the inability of residents to work together. The dominant ethos in the village was: "Maximize the material short-run advantage of the nuclear family; assume that others will do the same" [14].

Community is a simple word for a complex reality. A study carried out almost fifty years ago examined 94 definitions of community and concluded that, "beyond the concept that people are involved in community, there is no complete agreement as to the nature of community" [15]. Entrepreneurs who start new ventures are accountable to their investors and shareholders. Community entrepreneurs are accountable to the people in the places in which they operate. Management of their enterprises must be efficient and transparent. Initially, because of the focus on the social aspects of development many of those involved in community-based ventures saw sophisticated management as a threat and preferred to fumble through their days in the belief that amateur enthusiasm would make up for any deficiencies in running their organizations. They also believed that someone – usually the government – would protect them from the consequences of their folly and lack of management skills.

Small businesses do not survive unless they have marketable products or services. The same holds for community development corporations that require skilled salespeople. But enabling, facilitating, animating community ventures are not in the business of selling things. They seek to move people into action rather than spending time lamenting their problems or pointing out the deficiencies and ills of the world. Those who take up the victim stance in society place their fate in the hands of others, blaming them for their shortcomings. Through the process of social animation, which seeks to determine why people are behaving and doing what they are doing in an open and non-judgmental manner, it is possible to move individuals, groups and communities from dependency to self reliance [16].

Successful community ventures thus require people capable of identifying opportunities and barriers inside and outside communities, good managers, and animators who can encourage people to start solving their own problems with their own resources and those in the community.

None of this is easy.

Much depends on the leadership of community development ventures. All depend on individuals who see themselves as <u>prima inter pares</u> – first among equals. As in a business venture, someone has to take responsibility for making decisions. But the person on whose desk the buck stops has to see himself or herself as sitting at the hub of the wheel, not the apex of the pyramid. They have to work with boards of directors from the community – and individuals still finding their feet in ventures that are unique. These new entrepreneurs face conflicting goals, balancing social needs against economic demands. They must maintain good relations with governments – and with members of the business community who tend to view their activities as charity. Charity meets immediate needs. Justice, which is what community development is all about, seeks to change society so that charity is no longer needed. Community economic development initiatives strive to generate wealth and redistribute it, giving poor people a chance to find better lives through gainful employment, and to bring new life, new enthusiasm, new visions to communities sunk in poverty and apathy.

Teaching and doing community development becomes a transformative task. Participants are not treated like "hands," "factors of production" or "clients." They are encouraged to become active in all aspects of the operation, offering their ideas and suggestions on how to improve it. They are offered a mirror on their own beings in which they can see themselves anew and come to understand and accept their limitations while exploring their potential. In HRDA, some welfare recipients became managers of small enterprises. Community development ventures also offer windows on their wider worlds for those who work in them, taking them out of isolation and alienation into which poor and marginalized people often sink. They learn about new opportunities for personal development beyond the confines of their small communities – and how to gain access to them. Acting like seed pods, CED ventures send participants to new pastures to establish new lives based on what they have learned about themselves and the world while working for their own good and that of others.

They become sustainable people, able to earn a living and to have a quality of life acceptable to themselves as they continue learning about themselves and their communities.

In 1910, the American philosopher William James wrote an essay entitled "The Moral Equivalent to War" [17]. Its theme resonates through our time with particular urgency. Describing war as "the strong life…*in extremis*," James identified a central issue of his time – and ours. He asked how "the individual and collective heroism and sacrifice demanded by war [can be turned into] more constructive channels." Militarism demands many values that can be used for creative rather than destructive purposes: courage, comradeship, loyalty, hardihood, discipline, surrender of narrow interests, cohesiveness and willing to sacrifice oneself for others. These are the characteristics of community development at its best.

Underlying all efforts in this field is a strong moral basis, a belief that the world can be made a better place through the actions of human beings working together.

There is no mystery about the doors through which individuals, organizations and communities have to pass to achieve more control over their lives and operations. They lay in the liminal territory, the land between the thresholds of old ways of doing things and new approaches to solving the problems of personal and community development.

The changes include moves from:

Responding to crisis to Anticipating crisis

Reacting to change to Being proactive

Taking specific measures to Taking comprehensive measures

Requiring consent to Requiring participation

Dampening conflict to Confronting conflict

Detailed central control to Generalized central control

Standardized administration to Innovative administration .

Separate services to Co-ordinated services

Short planning horizon to Long planning horizons.

Again this is not easy. For example, everyone wants co-ordination in human efforts – but noone wants to be co-ordinated.

Community development in its various forms involves people working together and intervening in each others' lives. Alex Sim, a pioneering Canadian adult educator, articulated the ethical basis of attempts to help others:

"Intervention that is defensible on ethical grounds must always be paradoxical. One acts for others only to the point of initiating a symbolic gesture of genuine respect and concern. This is the first overture. There is further action if, and only if, the other responds positively. The response is much more than consent as we usually think of consent. After this accepting response, a spiral of action, reaction and interaction can result between the two. In the final act of love, who is to say who is the helper and who the helped. Then the notion of help is finally relevant [18]."

This sense of respect and mutuality, this feeling of moving up the spiral rather than following a linear path, infuses all worthwhile community ventures – and all successful business operations. These two very different ways of generating wealth and creating employment are not as far apart as might at first seem.

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Section 12
Selected Abstracts

European Union: Free Trade Agreement Chile - European Union
Luz Varela, Universidad de Los Lagos, Chile

Capital Markets: Globalization, Models and Tendencies in Latin America
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Managing International Joint Ventures in Emerging Markets: Thailand Experience
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Financial Characteristics of Companies Using the Fair Value and Intrinsic Methods in Accounting for Stock-Based Compensation
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The PPP Theory of Inflation Transmission: The Experience of Costa Rica
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Purchasing Power Parity and Inflation Variability: The Influence of Central Bank Independence
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Foreign Direct Investment, Financial Markets, and Entrepreneurial Activity : The Micro Companies and Their Financial Access
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Promoting Equity through Organisational Commitment : Progressing The Operationalisation of the Concept
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An Analysis on the Competitive Trend of Foreign Entry into Chinese Banking
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Mexico in the Back Room of International Trade
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Rio Vs. Marrakech: The Stalemate at Cancun
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The Trade and Investment Effects of Official Dollarization in Latin America
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Economic –Territorial Analysis of the Assembly Industry in Nezahualcoyotl Country and Surroundings
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ALCA: An Indecent Proposal?
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Internal and International Rural Day Laborers in Rural Markets of Work….
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To Decipher the Singing of the Mermaids: Social Imaginary and Migration
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Income Distribution and Inequality: Wage Rigidity and Conflict in Mexico
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Entrepreneurship Strategy and Enterprise Development
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Enterprise Resources Planning (E.R.P.): Development and Application at the Enterprise
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Financial Reporting of Small (Sized) Enterprises
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Strategic Analysis for the Small and Medium Enterprises (PYMES) Development in the State of Veracruz
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An Initial Investigation into Differences in Managerial Styles for Handling Changes in the Organization : A Comparison of Chinese and U.S. Managers
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Jeffrey Kantor, Liran Edelist, University of Windsor, Canada/ Bar-Ilan University, Israel

Marketing by Internet as Development of Business Strategy: Model to Implement Strategies for Business to Consumer
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The Application of Quality Function Deployment Method in the Auction System of Taichung Wholesale Fish Market in Taiwan
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What the Executives and the Businessmen Comment About the Valuation of Businesses and the Creation of Value in Mexico
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Learning, Continuing Education and Training: Entrepreneurs' Development
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Conditions that Favor Clusters Formation in the Provision Chain
Gabriel Fregoso, Ernesto Gonzalez, Juan Flores, Universidad de Guadalajara, Mexico

An Educative-Institutional Model for International Competitiveness Development : Application to Primary Sector Business Units
Oscar Valenzuela Sahagún, Jorge Franco Lopez, Monterrey Institute of Technology and Higher Education – Guadalajara Campus, Mexico/ Guillermo Orozco de Rosas, Foundation Produce Jalisco, Mexico

Knowledge Administration: Learning, Improvement and Training
Horacio Irigoyen, Mario Mena, Universidad de Morón, Argentina

Linking Business- University, from the Perspective of the Scientific Research : Limitations and Challenges of the Globalization
Salvador Gómez Nieves, Guillermo Vázquez Ávila, José Sánchez Gutiérrez,
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European Union
Free Trade Agreement Chile - European Union

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Abstract

The European Union is a set of organizations created between the countries of western Europe with the purpose of articulating mechanisms of economic, political and social cooperation that take to a progressive integration of these countries.The Agreement of Fourth Generation Extra signed in 2002 with Chile consecrates an asymmetry privileged for Chile. It is favorable for the agricultural, industrial development, the generation of use and the improvement in science and technology. The most important benefit of the Association of Chile with the European Union is the "Creación of Commerce".

The Agreement with the European Union represents a very important opportunity for the productive sectors of the X region of Chile. The regional activities that will participate in this commercial interchange are: Agricultural Sector - Cattle, Sivícolas and Pesquero.

Capital Markets: Globalization, Models and Tendencies in Latin America

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Abstract

In recent years, the globalization of financial markets has grown in an astonishing manner. The economies have allowed the deregulation of domestic markets for free circulation of capital flows and also of participants of the worlds' main financial centers. Also, technological improvements have enabled in a considerable manner monitoring of markets all over the world - their operation, financial opportunities, etc.

We have the foundations and models used by investors to form their investment portfolio. Whereas, the Arbitration of Prices Theory (APT) states that profit of an asset is a function of several, an interesting feature of the APT model is that it supposes very little about investors and market structure.

Now, in the event of Latin America, privatization of asset values has recently grown, as well as the placement of sovereign, governmental and municipal debt within capital markets. This makes global capital flows in these economies much more competitive.

Managing International Joint Ventures in Emerging Markets: Thailand Experience

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Abstract

International Joint ventures (IJVs) are critical concern for international business because of their growing strategic business environment, especially so in Thailand where IJVs have become very common. There are various reasons for the increasing use and importance of IJVs. This being the case, a study has been conducted with the objective of promoting a better understanding of how firms proceed in managing IJVs. The emphasis is on identification of strategies which firms employ when seeking the competitive advantage of IJVs. The study aimed to gain insight into the strategies adopted and the managerial perspective of IJVs in emerging market of Thailand. This paper presents the findings of a research on fourteen randomly selected IJVs in the manufacturing sector of Thailand, based on focused interviews with foreign and local managers.

Financial Characteristics of Companies Using the Fair Value and Intrinsic Methods in Accounting for Stock-based Compensation

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Abstract

A lot of attention is being focused these days on the accounting choices made by public companies in U.S. primarily due to the scandals related to fraudulent reporting in the last few years. Many changes have been precipitated due to these scandals, not the least of which is the formation of a new governmental oversight body to regulate auditors under the Sarbanes-Oxley Act of 2003. One of the many reasons given for the pressures on U.S. companies to fraudulently report high earnings is the use of stock-based compensation packages to reward top executives. Since most of the companies use the older intrinsic value method to account for these stock options, as opposed to the FASB recommended fair value method, some argue that the "real" cost of the compensation package is understated in the intrinsic method, giving executives an incentive to overstate the earnings in the short-term that the options vest to maximize their own returns at the expense of the stockholders. After the accounting scandals the FASB has been under pressure to re-examine this issue and not surprising the board has recently announced that it will study this issue and release a new standard. In addition some companies have voluntarily chosen in the last two years to expense the options using the fair value method. The Intemational Accounting Standards Board (IASB) has also proposed a new standard for this area in the international reporting arena. The purpose of this paper is to examine the accounting method utilized by U.S public companies in reporting stock-based compensation packages in their most recent annual reports. A comparative analysis will be done of the companies choosing the recommended fair value method of accounting for stock-based compensation packages versus the intrinsic value method. The results of the study will be useful for the regulators and the market place in examining the motivations of companies in using the two methods of accounting for stock-based compensation packages.

The PPP Theory of Inflation Transmission: The Experience of Costa Rica

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Abstract

From all indications a Free Trade Area of the Americas will be a reality by 2010. Many of the smaller territories of the Central America and the Caribbean will join even though somewhat reluctantly. This paper examines one of the sources of that reluctance: currency instability. Using the absolute version of the purchasing power parity theory, the paper models the nominal exchange rate and the price level as integrated processes to ensure that trade between two countries will render the real exchange rate as a stationary process. Employing the Johanssen Cointegration technique, the paper investigates whether the current inflation differential accounts for the difference between the present and previous exchange rate levels for Costa Rica and the US. Given the tight trading relationship between the two countries, the PPP theory is expected to yield robust results. Finally, within this context we investigate the persistence patterns of exogenous shocks such as the episodes of devaluation of the Costa Rican currency.

Purchasing Power Parity and Inflation Variability, the Influence of Central Bank Independence

Hermann Sintim – Aboagye
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Abstract

Under the Purchasing Power Parity (PPP), changes in relative prices account for exchange rate fluctuations between economies over time. Specifically, PPP postulates that exchange rates adjust to the differences in relative inflation at home and abroad. In essence the behavior of inflation affects the stability of the price of currencies and therefore the exchange rates. Empirical studies provide some evidence in support of the PPP; results have been stronger in the mid to long run time frames but relatively weaker in the short run. Empirical and theoretical expositions establish an inverse relationship between the degree of central bank independence (CBI) of an economy and the level and stability of inflation rates. A verifiable implication of the latter relationship is that, the higher the CBI the lower and less variable the inflation rate. Given the influence of CBI measures on the behavior of inflation, and the relationship between the relative inflation and the movement of exchange rates between two economies, a testable proposition would be to investigate the influence of CBI measures on the efficacy of PPP across sets of countries.

Arguments have been presented to the effect that PPP would likely hold stronger in high inflation situations because currencies of these economies will be more sensitive to price changes (Leith, C. J. (1991)). On the other hand, intuition will suggest that economies with relatively stable inflation rates will be less 'noisy' in terms of inflation variance and will more clearly impound any small changes in the pricing of currency. Either way, given the CBI-Inflation relationship, CBI measures may influence and explain the tenancy of PPP theory. The objective of this study is to investigate to what extent CBI measures explain the PPP argument.This paper extends existing CBI and PPP literature by developing a functional form that relates CBI to the first and second moments of inflation rates. This approach entails the use of a maximum likelihood framework that facilitates the direct inclusion of CBI parameters in the residual covariance matrix. This method allows for a more intensive use of information contained in the CBI indexes and the estimates obtained are perhaps more better reflective of CBI influences on the behavior of inflation. This paper demonstrates that there are significant differences in the residual variance of inflation that can be attributed to the measured degree of central bank independence. The next step will be to examine the latter relationship within the context of the PPP theory.

Foreign Direct Investment, Financial Markets, and Entrepreneurial Activity
The Micro Companies and Their Financial Access

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Abstract

In analyzing the economic structure of a country, we have found that its productive chain is governed by the coexistence of companies from different span. Upon analyzing the sectors determined in the different countries we found the same phenomenon. We are postulating that the dimensions of a company are not related with a certain sector of activity. Neither exist countries nor economies that demand a certain level of activity so that someone can create a company. MIPYMES should play an important role in the globalization of trades, and the exchange between big economic regional blocks. Micro enterprises are made up of the most diverse range of products and services. They have been begun for people who need to increase their revenue, or by those who have lost jobs or by those who are venturesome.

Promoting Equity through Organisational Commitment: Progressing The Operationalisation of The Concept

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Abstract

One tool for the provision of equity in the workplace is organisational commitment, which can deliver equity by providing benefits to both employers and employees. Despite a rich literature there has been a failure to operationalise the concept.

This paper examines causes of this failure. The literature is examined in three areas, each relating to part of the notional antecedent/organisational commitment/consequence relationship underpinning research in the area. Six factors restraining the operationalisation of organisational commitment are identified: lack of a general model explicitly linking organisational commitment to strategy; lack of a comprehensive theory-based categorisation of antecedents; lack of agreement as to the correct level of analysis or consideration of inherent assumptions; lack of agreement regarding what the concept properly embraces; the relative lack of empirical research into the consequences of commitment; a method of evaluating the usefulness of antecedent and consequence research.

A two dimensional framework for assessing the usefulness of antecedent and consequence relationships with organisational commitment having regard for corporate risk is proposed and successfully tested, offering a solution to one of the above limitations. Further research is foreshadowed.

An Analysis on the Competitive Trend of Foreign Entry into Chinese Banking

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Abstract

With the acceleration of foreign entry into Chinese banking sector after China's joining the WTO, the competitive trend between foreign and domestic banks in China has become intense in China. This paper presents a quantitative analysis of the current situation of foreign banks in China. And further, the competitive advantages or disadvantages between foreign banks and domestic ones have been described. We discuss the concept of "cherry picking" that foreign banks commonly apply in emerging markets such as China. These competitive tactics has been classified into four aspects (region/client/business/talent). There are expected to be the most fierce competition area for foreign and domestic banks in China in the considerable future.

Mexico in the Back Room of the International Trade

Jaime Ramírez Ramírez
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Abstract

This document presents/displays analysis from two different perspectives. First of these is the position of Mexican economy from foreign trade and the second is the disadvantage which it represents to commerce that turns it into a quite vulnerable country before the attacks of foreign economies, mainly those of the Asian block.

Rio vs. Marrakech: The Stalemate at Cancun

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Abstract

The stalemate at the fifth ministerial summit of the World Trade organization (WTO) at Cancun, Mexico has opened the season for the blame game. The developed as well as the developing countries, the global business communities and the non-governmental organizations are finger pointing at each other. The paper argues that the stalemate is the necessary outcome of a conflict between the two policy regimes that have evolved in the last 30 years and are attempting to govern economic interaction in the global arena. These two regimes are inconsistent and sometimes are in open conflict with each other. The one regime, guided by free market ideology, aims at ushering in a borderless economy, polity and homogenized (Americanized) human world. It strives to establish an even playing field for free mobility of global finance with a promise of higher economic growth for all participants. This regime culminated in the establishment of the WTO at Marrakech in1994 as a judicial arbiter to resolve all disputes and is backed by the structural adjustment policies of International Monetary Fund (IMF) and the World Bank. The other policy regime, crystallizing in the Rio agreement, seeks to establish a regulatory framework to promote ecological stewardship, equity and cultural integrity. This framework is the product of international agreements on climate, bio-diversity, forests, endangered species and various codes of conduct. These agreements are not guided by a single ideology but are compromises about actual needs of diverse interests. In the last decade, Marrakech seems to be winning and marginalizing the Rio regime. The Doha Declaration established a work program that would solidify this outcome. The Cancun statement indicates that this onward march of Marrakech over Rio has been halted. The paper offers some comments about the possible scenarios and outcomes.

The Trade and Investment Effects of Official Dollarization in Latin America

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Abstract

Globalization is bringing the countries of North and South America closer together. One trend which has gone virtually unnoticed is full dollarization in small countries of Latin America, such as Ecuador and El Salvador with Guatemeala a possible third candidate. Distinct from Argentina, these countries decided to go a step further than fixed exchange rates and currency boards—they have abandoned monetary policy altogether in favor of using US dollars for transactions. For many years few central banks in Latin America have been able to deliver on their mandate to maintain price stability. This has hindered economic stability and growth. Dollarization holds new promise for elusive economic stability. Economics analysis would predict that a single currency facilitates trade and investment between the countries using it because it eliminates transactions costs, improves efficiency and business confidence. Thus, using the US dollar should expand international business between those Latin American countries and the United States. This paper looks at trade and investment between officially dollarized Latin American countries and the United States to determine the extent that dollarization has contributed to international business among these countries and make some predictions for the future.

The Concept and the Type of Assembly in México

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Abstract

With the prevailing trend of globalization and relaxation in economy world-wide and the políticis of opening and liberalizatión implemented by Mèxico, everything seems to aim at fortifying the pattern of accumulation or “development of style” supported in a process assembler. The investments of the trans-national capitals accelerate exportable products scattered in the national territory.

In order to integrally explain the meaning that has the maquilador process in country peripheral, like México, the paper is divided in these parts:

1.Dimensions and concepts of assemble
2.Internal and external factors that determine the location of assemb le
3.International and national customs regulations that favor American capital to settle in Mexico through the promotion of the IME in this sector.

Economic-Territorial Analysis of the Assembly Industry, in Nezahualcóyotl Country and Surroundings

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Abstract

For more than twenty years, and because the lack of industrialization, some economies have been hidden in the manufacturing companies, as this is a way of generating jobs and a way to activate the economy. In the short term, these kind of enterprises have grown and become a production option in the world. In Nezahualcóyotl County, there has been an important development in clothing manufacturing. This has become a core economic activity and is now considered as the main work and income source for the people in this area and nearby communities. This service is widely offered to a variety of enterprises in Mexico City, its surrounding area, and, even, to foreign markets. This paper analyzes the featuring characteristics in the development of the manufacturing industry in Nezahualcóyotl County and surroundings. It revise the historical development of manufacturing enterprises, and analyzes the current situation of manufacturing enterprises and its future for production automation.

ALCA: An Indecent Proposal?

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Abstract

This paper reports part of a study of different elements of the ALCA that are currently being developed by the Group of Investigations in Regional Development and International Competitiveness of the Faculty of Economics and Administrative Sciences of the Universidad Tecnologica de Bolivar. The historical and conceptual approaches of the theories of international trade try to establish elements of critical thinking about the relevancy of ALCA for Latin America. The paper attempts to establish if this is profiled more as an indecent proposal or in fact, as a unique opportunity for the hemisphere and the developing countries.

Internal and International Rural Day Laborers in Rural Markets of Work

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Abstract

The objective of this work is to analyze the changes in the migratory currents of rural day laborers. In addition, the study measures the impact of migration from the following considerations. How the expansion of the harvested area of vegetables in California, USA, combined with the deterioration in the conditions of life of the rural population in Mexico, have caused an increase in the internal migrations and an expansion to international markets of work. This work is developed from a study of migrations from the countryside in the state of Baja California of the Mexican Republic and its link to Imperial Valley in California, USA.

To Decipher the Singing of the Mermaids: Social Imaginary and Migration

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Abstract

This article is part of an investigation that was carried out on the migrant lives of Tala, Jalisco. After reviewing a series of previous studies on the migration, it was observed that they lacked certain perspectives namely, the vision that the migrant one has of himself, and the explanation that the migrant gives to the situation., before The object of project to study the relation of one's own collective imagination with the migration of their (inhabitants of Tala, Jalisco) to United States. Even though the main causes of migration are the poverty and the unemployment; nevertheless, it was observed that other reasons of subjective kind coexist. These are the desire of adventure, the need to participate in an initiation rite of virility, the illusion to maintain a united family or to flee from a social repressive situation.

Income Distribution and Inequality: Wage Rigidity and Conflict in Mexico

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Abstract

According to neoclassical literature about labor market, wages are the opportunity cost among leisure and consumption, however, we need more arguments in order to understand the recent evolution of wages in Mexico. Education, age, gender and geographic location are very important arguments that explain the frame of wages in all regions of this country. Again, following the neoclassical theory of economic integration, wages will approach wages in the partners countries,. If 90% of Mexican trade is with United States, we will expect an approximation of wages and salaries with the U.S, but this is not true.

The polarization of the income process in Mexico is reflecting the diminishing weight of the "middle class". The bimodality of income distributions in some countries increases the probability of conflicts. Mexico is already part of a commercial block looking for free trade; however, convergence in wages and salaries is far away. Polarization process is coming with particular force due to the NAFTA and the lack of labor reform. We want to explore the recent evolution of wages and salaries, and use our results in order to understand the global challenges in labor market mobility.

Entrepreneurship Strategy and Enterprise Development

María Correa
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Abstract

This paper analyzes the entrepreneurship strategy to establish the factors that affect the enterprise' financial performance, the enterprise' performance in general and the enterprise's success or failure. There are very diverse strategy types for entering in new business. The performance of the company depend so much on the strategy that is implemented, the abilities of the entrepreneur or the abilities of the entrepreneur team and the type of the industry. The firm should choose appropriate strategies and to implement them to achieve excellent results and to achieve a sustainable competitive advantage on their rivals.

We consider three basic strategies– be a low cost producer, be the producer with the best quality and be a producer based on the time that can lead a company to be successful in the achievement of the high growth in their results.

Enterprise Resources Planning (E.R.P.): Development and Application at the Enterprise

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Abstract

The focus of this research is to understand the ERP - its applications, its usefulness in improving the processes and reducing the decision making time. AN ERP system can be applied to enterprises of all sizes - small to medium to large. With the help of an ERP system, finance reports could be ready in hours instead of days. The accuracy and the reliability of the inventories could be more than 99% if we want to apply a Just In Time system. Also, developing an application to manage some specific area if we do not have resources to use all ERP modules, will bring good outcomes.

Financial Reporting of Small (Sized) Enterprises

Marie Paseková
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Eva Hýblová
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Abstract

Small and Medium (Sized) Enterprises (SMEs) have an irreplaceable role in the economies of all countries. Each country endeavours to support its SME sector through a variety of programmes. The aim of this contribution is to provide information about the financial reporting practices of SMEs in the Czech Republic in comparison to the requirements ensuing from implementation and conformance with international standardisation efforts for Accounting practices. The Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) has identified a number of problems experienced by such SMEs in the course of their accounting practices. The accounting practices of SMEs is based on the double-entry bookkeeping system but with certain granted reliefs, which are as follows: a simplified approach to the applications of the Accruals Principle, a simplified accounting structure, and a standardised format for Accounting Statements.

Conceptual Model for the Development of Strategies of Electronic Commerce for the Small and Medium Companies

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Abstract

The future is bright for electronic commerce. It has been forecasted to increase in from $109 billion in 1999 to $1.2 trillion in 2003 (Forrester Research, 1999) to as high as $7.3 trillion by 2004 just in the U.S. (Gartner Group, 2000). Global transactions are predicted to be $105 trillion by 2004 (Gartner Group, 2000). In spite of this, many small and medium sized enterprises (SME'S) that owe their current success to their entrepreneurial spirit, have shied away from electronic commerce technology and most of them are ill-equipped to capitalize on the Web's full potential for enhancing their marketing efforts, perhaps because their executives do not fully understand the potential of Internet marketing. The same is true for the Mexican SME's. Given this facts it is obviously critical for the SME's to develop strategies that link them to the online marketing world. To address this issue, this paper makes a review of the authors who studied the planning behavior of successful e-commerce companies and/or proposed alternative planning models, and offers framework for developing a e-commerce strategy. The model proposed integrates the main proposals from these authors and was adapted to the Mexican companies' environment and characteristics.

The Dark Side of Strategy

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Abstract

The essence of the final decision is always missed by the beholder and it is often missed by the one who takes the decision. In the process of taking decisions there will always be a dark and mysterious hole. Those words belongs to John F. Kennedy, and describe a reality: each decision has to be based in principles or techniques to be effective.

In organizations, as well as in public life, people have given priority to values. The current key to success of modern organizations is in the building of a system of values adapted to people's necessities. Such key to success has not been clearly identifiable for managers, shareholders and clients. Nowadays, it constitutes the invisible support to implement any organizational attempt that intends to be successful. This is what is called the dark side of strategy.

Strategic Analysis for the Small and Medium Enterprises (PYMES) Development in the State of Veracruz

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Francisco Ballina
Universidad Veracruzana and Universidad Autónoma de México, Mexico

Abstract

The main objective of this paper is to analyze the Pyme's situation in Veracruz, taking into account these factors - their strategy and main competitive factors; their organizational and human resources structure; technology indicators, quality and innovation; level of information and communication technology use; and different accounting and financial aspects. We will determine the competitive strengths of the Pyme and define the main difficulties for their development. Also, we will propose actions for the Pyme competitive improvement and success.

An Initial Investigation into Differences in Managerial Styles for Handling Change in the Organization: A Comparison of Chinese and U.S. Managers

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Abstract

A survey MBA students in China and Charleston, USA, was used to find differences in management styles between Chinese and U.S. managers. Fifteen vignettes – delicate situations requiring managers to handle problems – were given to these managers and their responses were analyzed to determine cultural differences. There were three categories of vignettes: seven involving values, five dealing with conflict resolution, and three in which managers had to deal with change in the organization. This paper will outline the results of the first two and talk in some detail about the results from the three situations dealing with change.

On Operational vs. Accountancy Approaches to Earnings Management

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Liran Edelist
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Abstract

Enron, WorldCom, Tyco, Qwest, Xerox, and 3Com are just a few of the prominent companies that been implicated in Earnings Management scandals. During the last year, two of these well-respected companies (Enron and WorldCom) went bankrupt following investigations and indictments by the U.S. Securities and Exchange Committee (SEC). Growing concerns about this phenomenon led to a demand in August 2002 that managers of the top 1,000 American companies (with company values of over $1.2 billion) submit their financial statements under oath. Managers have the ability to influence financial statements by 1) allocating and re-directing company resources (operational approaches) and 2) by choosing/changing to different accountancy methods (accountancy approaches).

The chairman of the SEC, Arthur Levitt, has expressed his deep concern over the growing phenomenon of earnings management. He argued that earnings management should be eliminated "For the sake of our markets; for the sake of our globalized economy which depends so much on the reliability of America's financial system; for the sake of investors; and for the sake of a larger commitment not only to each other, but to ourselves " (Levitt, 1998).

Should revising depreciation methods or inventory figures be considered less ethical than postponing expenditures or planned maintenance? Can we justify a manager who uses earning management to increase a company's profit? How does this compare to a manager who uses earning management to show a decrease in profits? Is there a difference because of gender? Do managers have different views to non-managers? The sample group in the research comprised 132 MBA students. Each questionnaire included 13 questions designed to measure the sample group's views on earnings management. Two situations are presented in which there are managerial dilemmas that provide a basis (pressure) to engage in earnings management. In situation A, the manager learns that the company's profits are far above the projected level. This achievement is considered a one-time phenomenon, so the manager is interested in understating its profits in order to avoid creating expectations for similar results in the future.

Marketing by Internet as Development of Business Strategy: Model to Implement Strategies Business to Consumer (B2C)

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Abstract

This work presents the basic concepts of the e-commerce as they are pointed out in the contributions of Whiteley (2000), Gordon (2000) and Plant (2001). It continues the study with the work on marketing by Internet, referring to the topic that Janal (2000) denominates the differences between on-line marketing and traditional marketing. The study presents the diverse stages to establish marketing strategies in web, which is the basis for the proposal of a marketing model for internet. Finally we conclude with a model to implement marketing strategies of business to consumer (B2C) that can be adapted for the small and medium companies.

The Application of Quality Function Deployment Method to the Auction System of Taichung Wholesale Fish Market in Taiwan

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Lin Ya-Chuan
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National Chung-Cheng University, Taiwan

Abstract

As an important channel of marketing fish and the medium between fishermen and consumers, a wholesale fish market not only controls the supply and demand of fish but also functions as the center of fair-trading. Therefore, the Council of Agriculture in Taiwan makes best effort to improve the fish-trading environment, to construct and promote open fish trading system, to increase marketing efficiency, and to carry out the computer auction system. However, unlike countries in which there are few kinds and large quantities of fish, Taiwan's fish are various and each kind is in a small quantity, which are hard to manage so as to cause slow development in automated auction of wholesale fish markets in Taiwan. Presently, 21 computer auction lines are set up only in the four wholesale fish markets of Pu-Shin, Chiayi, Taichung, and Hsin-Chu. (Council of Agriculture, 2003)

The computer auction system, in place of the traditional auction way, allows the buyer to see and touch goods. The buyer bids and trades with the bidding machine, which not only makes the whole trading process totally open and fair, but prevents man-caused mistakes as well. In this way, both the seller and the buyer trust each other and recognize this system. Because the open bidding process encourages more buyers to bid, the fish price is raised 0.1 American dollars per kilogram and thus increases the income of fishermen. Besides, manpower can be saved through the computer auction system, which can instantly prints out the detailed list of trading and provides it for the seller to receive money on the spot and for the buyer to check the quantity of fish goods. As for the wholesale fish market itself, the suppler trusts the trading system so is willing to entrust all kinds of fish products to the market for auction, and this boosts the business of the market.

The focus of this study is to study the operational quality in the process of Taichung wholesale fish market in Taiwan. There are numerous trading products in Taichung wholesale fish market, and about 7500 fish products are sold out; the trading process is still in order in spite of high trading demand just due to the implementation of the computer auction system which brings about systematic arrangement of fish goods from all over the country. Both of the seller and the buyer are able to check current prices of any fish at any single time in the whole market, and the inquiry into the wholesale market.

In the application of the automated auction, a sound auction system is the pivotal mechanism to maintain good quality of trading. To the wholesale fish market, the buyer is the customer. Nowadays, the customer's requirement is tougher and tougher, so quality management can't stick to prevention; on the contrary, what the wholesale market should put emphasis on in quality management is to positively and rapidly reply to the demand of the market, and to gradually become customer-oriented management.

To precisely understand the Voice of Customer, the company can use the Quality Function Deployment Method, QFD, regarding the customer demand as the important index of company improvement, and finding out the most effective strategy for quality improvement. Thus, through the application of QFD, our research will discuss the pivotal factors that have an influence on the efficiency of the operational process of the wholesale fish market, and analyze the main demand and concerns the buyer has about the automated auction and its system so as to provide information about improving the auction operation quality; further, the whole auction efficiency will be increased to better the computer auction system. In this way, the auction market will be able to function perfectly.

The Market Orientation and Its Influence on Relations Between Members of the Channel of Pharmaceutica Chemical Agent Distribution in Jalisco

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José de Jesús Urzúa López
University of Guadalajara, Mexico

Abstract

The present work explores the degree of adoption of the market orientation approach that the product distributors of chemistry-phamacists in Jalisco perceive in their suppliers.The study begins with a perspective from the market approach and an empirical description of the management approach. This is based on a sample of 54 pharmaceutical chemical agent distributors in the Metropolitan Zone of Guadalajara. The results reveal that the companies of the sector are not highly oriented to the market. We discuss three comp onents of the market orientation. These are the generation of market information, the dissemination of the information by the organization, and the component of organizational response.

What the Executives and the Businessmen Comment about The Valuation of Businesses and the Creation of Value in Mexico

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Abstract

We interviewed 13 businessmen and executive of high level in relation to:

?? Their personal experience in processes of valuation of businesses with purpose of fusions, splits, alliances, acquisitions or sales.
?? The methods that they recommend to value a business.
?? The importance of the intangible in a process of valuation and negotiation.
?? The obstacles that are presented in these processes.
?? The recommendations that they give us for future processes of this type.

We present the results of a survey applied to 371 postgraduate course level executives.
The fundamental purpose of the survey was to know the following aspects:

?? Which methods the businesses use to measure the generation of value?
?? Which financial indicators the businesses use to measure this generation of value?
?? Any relation of value creation with the different programs of incentives for the businesses?
?? What advantages have been achieved when applying some of these methods?

Learning, Continuing Education and Training: Entrepreneurs' Development

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Universidad de Morón, Argentina

Abstract

The impact of globalization in Latin America has created a significant fall in the generation of business opportunities and on the contrary a strong trend, in fairly- trained young people, to migrate to some of the central countries. Due to a demographic policy developed in these countries, where segregation and the policies tending to admit immigrants "qualitatively interesting", a very outstanding characteristic is to absorb individuals with some basic skills and with a particular emotional disposition turning them into operating elements of the society.

Taking into account that at every moment and in every society, the paper postulates that there exist individuals who have at least a positive emotional disposition for the development of innovative activities. This paper aims to the possibility of implementing proper policies for the different countries of the region to promote a wide variety of activities in their own country.

When the Governments and social institutions of all kind are devoted to the task of individually, collectively and regionally promoting innate skills and others to be easily acquired with the purpose of making up potential enterprising individuals, that phenomena may not only change but complement with a series of structural rules tending to create a different "culture" capable to show a unique social view to the whole society.

Conditions That Favor Clusters Formation in the Provision Chain

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Abstract

The international buyers insist on obtaining better quality, shorter response times and lots. In the words of a manufacturer from India, as commented by Hubert Schmitz comments (2000), "…is demanded to us that we produce to prices of the Third World, but with quality of the First World." This summarizes the challenge that companies of the developing countries face in competing for the export markets. The conditions that favor the formation of clusters in a particular geographic area are not understood completely. Nevertheless, the present work shows evidences of some determining factors in the internationalization of the supply chain. It discusses that a set of companies with the necessity to face the international competition must work together to establish a common strategy, thus forming clusters that help them to compete. On the other hand, the export represents a viable strategic option so that the companies are internationalized. This caused the interest in the last two decades to investigate the determinants of success in the exporting companies (Zou and Stan 1998).

An Educative–Institutional Model for International Competitiveness Development: Application to Primary Sector Business Units

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Guillermo Orozco de Rosas
Foundation Produce Jalisco, Mexico

Abstract

The globalization process is stronger and more evident than ever before. It is characterized by the enormous importance given by customers to quality, price and competitiveness of products. This situation creates opportunities and challenges for small and medium size business units included in the primary sector. In Mexico, the agricultural sector has been disarticulated from the rest of the domestic economy and has lost international competitiveness in the last thirty years. Nevertheless, the comparative advantages of production and the recent openness of the country to foreign markets–through commercial liberalization and free trade agreements–underpin the possibility for firms and growers to participate in markets all over the world. Using a model that combines the profile of international business students, rural development programs of non-for-profit organizations and public resources of government agencies, we provide the essential guidelines and organizational knowledge to generate international competitiveness that allow primary sector business units to compete successfully overseas in the short term.

Knowledge Administration: Learning, Improvement and Training

Mario Mena
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Universidad de Morón, Argentina

Abstract

According to the Darwinian view in economy and business, the closures of enterprises are balanced with the appearing and emerging of new ones. Enterprises do not appear spontaneously. They are the result of a succession of social and individual phenomena which determine the existence or absence of initiatives and the beginning of a special "spirit". Considering the Argentinean case, we find that in the 90s the closures were more than the openings.

One of the basic conclusions is that the university has a crucial role. The society needs to rethink the university's mission, the teaching-learning structure and the improvement of the learners' skills that .could be different from general skills. The prevailing academic structure shapes suitable individuals to work in organisations, to understand and to use technologies. It does not teach how to investigate, create, adapt and develop new technologies, which generate new enterprises.

The social importance of the university degree in Latin America goes beyond that of the executive and, at the same time, this factor withdraws the professionals and researchers from the practical field of the transfer of the scientific approach to the applied technology. Once the causes are known, it is possible to try to modify and anticipate its effects. For that reason, it is essential to redesign the universities' vision and mission in Latin America. The direct involvement of these in the process of encouragement and development of the students' ever-growing capacity will support, help and develop business initiatives.

Linking Business- University, from the Perspective of the Scientific Research: Limitations and Challenges of the Globalization

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Guillermo Vázquez Ávila
José Sánchez Gutiérrez
Universidad de Guadalajara, México

Abstract

This work presents the topic of the linking universities with business sector. However, in spite of recognizing the importance that this process represents for the sustainable growth in Mexico, this has had a slow development for the lack commitment among both sectors. Such linking was recommended by the United Nations for Education, Science and Culture Organization (UNESCO) as a strategic point in the Conference of the Americas (1998. Also, the Education National Plan of 2001-2206 (2000) integrated the vision and the strategic lines for higher education in Mexico.

Universidad de Guadalajara's general policies, detailed in the titled document: "Setting about to the University Plan of Institutional Development 2002-2010 (Universidad de Guadalajara, 2003)", state that research stays as a strategic element of development. Where it reinforces the links among university, society and government; self-critical evaluation of the program is promoted. The present study starts from the premise that the Higher Education Institutions (HEI) that are interested in the relationship with the productive sector would learn from the successful experiences of other universities This paper incorporates the experience of case studies of the Administrative Economics Science University Camp us (CUCEA), where the students carry out activities to develop administrative and managerial abilities (diagnostic, taking of decisions, observation, to know how to listen and to convince) while they are granted to the company consultantship services. Als o, the students are sensitized about the responsibility of taking real decisions in a practical environmental context.

Finally, a proposal of Long Term Development Plan is presented for the linking of the CUCEA with the diverse sectors.

Core Competences in Higher Education: Case of the Faculty of the University Center for Economic and Business Administration Sciences (CUCEA) of the Universidad de Guadalajara.

Verónica Baños
José Sánchez
Edgar R. Ramírez
E. Georgina González
Universidad de Guadalajara, México

Abstract

In accordance with the analysis carried out by Hamel and Prahalad (1994, 1995, 1998, 1999, 2002), a core competition consists of an element or a group of elements that are unique and very difficult to imitate by its competitors Other authors like Levy and Leboyer (1997), Van der Heijden (1998), Hoskisson, Ireland and Hitt (1999), Rastogi (2003), Goldberg (2003) have analyzed and directed their studies to the difference among the resources of the company (tangible or intangible) and whether these resources are really critical competencies.

Given the relevance to know and to identify the core competences in an organization, a field study is made at the Center for Economic and Business Administration Sciences (CUCEA) of the Universidad de Guadalajara, where the main critical competitions of the faculty of this center are detected.

The present work has as objective, to present the advances in the pursuit to the strategic plan of the CUCEA, to develop the critical competences detected in the faculty which will serve like one of the tools to improve the position of campus competitiveness.

Competencies of Outstanding Faculty Members of Business for Schools 21st Century

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Abstract

Based on future changes in faculty evaluation practices, this paper examines the key competencies of outstanding business faculty members in a Mexican university. The survey is based on the nominal group technique, personal interviews and students teaching evaluations. Our sample of the survey is 19 staff directors of different areas of Business School, 13 full time professors and 2500 students. The purpose of the survey is to determine the key competencies of high performance faculty members, identifying the weight given to competencies related to personal attributes and the weight given to competencies related to work. This survey will contribute to faculty personnel decisions such as merit pay, promotion and rewards. Our assumption is that competencies related to personal attributes will be higher in outstanding performance faculty members than competencies related to work. This approach is applicable not only to faculty member but also to any kind of employees within organization.

Higher Education and Income in Mexico

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Abstract

The aim of this research paper is to demonstrate, for the case of Mexico City, the positive relationship between educational level and individual income. This paper also analyses other income determinant factors, such as gender, organizational job level and worked hours, to determine the exact impact of education level on individual earnings. For this we have used the micro data of the National Survey of Urban Employment (NSUE) for the third quarter of 2002.

The central emphasis of our research is in higher education, taking into account the differences in personal earnings of those individuals who advanced through different professional career stages and hold different academic degrees. We also focus on the way the educational level is concentrated amongst the different income earners deciles. The result of this research has lead us to a set of conclusions and considerations that could be useful for the design of a national educational policy.

Facilitators and Constraints in The Global Transfer Of Knowledge: Examining The Role of International Assignments

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Abstract

International business practices are increasingly requiring cross-cultural transfer of knowledge, values, and experience as companies recognize the need to operate both locally and globally in a challenging and volatile environment. Managers are urged to adapt management practices to suit local contexts, to coordinate the work activities of multicultural groups and to integrate their operations into a global knowledge economy. Yet there are differences about the importance of international assignments as a vehicle for transferring global knowledge. Some companies consider international assignments as critical in transferring global knowledge, with global employees acting as a kind of organizational "glue" to facilitate the process. Others believe that moving people around and putting people in foreign settings doesn't necessarily result in the global transfer of knowledge or in the "right" attitudes that make a company global.

The purpose of this paper is to examine first, the extent to which companies use international assignments to facilitate cross-cultural transfer of knowledge, values and experience. Second, to what extent are these goals reflected in criteria for the selection of managers for international assignments, as well as in practical training for assignments. Third, what are the implications for using international assignments to facilitate the global transfer of knowledge in a volatile environment? We conducted a series of interviews with a senior Human Resource executive in 28 global companies. Of the companies, 21 were headquartered in the U.S. and 7 were headquartered in Europe. At the time of the interviews, the annual global sales of the companies ranged from $3.5 billion to $52 billion dollars and the worldwide number of employees ranged from 7000 to 13,200.Overall, international assignments appear to serve as constraints rather than facilitators in the global transfer of knowledge. The pattern of results indicated that companies overwhelmingly use international assignments on a limited basis to transfer technical skills rather than rather than management knowledge, values or experiences. For only three of the companies was there strong emphasis on transferring global knowledge and developing global talent, but selection in these companies was focused at the executive level as part of a broader development program. There was limited pre-departure training for international assignees in general and very little that dealt with transfer of knowledge either explicitly or implicitly. We discuss the implications of these findings and suggest ways for using both international assignments, and networks to facilitate the global transfer of knowledge. Directions for future research are discussed as well.

Coaching-Processes in the Future

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Abstract

During the last few years the significance of the so-called "soft skills" in the entrepreneurial activities has considerably increased. Very often the personal development does not keep abreast with the continued changes requiring a success promising adaptation. Hereby it is worthy to bear in mind that the personal aspect of the management personnel or that of employees plays an important role, and the orientation towards employees becomes still more and more important success promising factor of management behaviour. The adequate coaching measures represent a possibility of achieving fast, global and entrepreneurial development. Nevertheless, it is already evident that based on the various demands imposed on the coaching, being an instrument of personal development, various interpretations of this term have already been developed both in the literature and praxis. At present, the term "coaching" is taken as a common term for a number of various interpretations. Coaching cannot be taken for some new fad anymore as it has arisen on the basis of market demands. Coaching proves to be useful instrument within the scope of personal development for the purposes of a constructive response on competitions and challenges. However, the success of the coaching measures depends in a decisive manner on the readiness to integrate the coaching into the scope of business activities and to take it as an instrument worthy to be considered seriously. The coaching being already more or less established as an instrument of personal development, now there are less questions about the understanding of the term of coaching than about its effective use for the internal personnel work. Hence the new approaches thereof are considered and analysed in this paper.

Quality of Labor Life on Institutions of Superior Education
Case of University of Guadalajara

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Jorge Barba
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Universidad de Guadalajara, Mexico

Abstract

The paper is the result of a research project called "The human's talent management on Institutions of Superior Education". Topics included in the project were the impact on the quality of life of the employees – both current and retired, the acceptance of the new pension and retirement system at the University of Guadalajara, and the management of the human resources.

An exploratory, descriptive, case-based methodology was applied. The research results discuss the management of intellectual capital in the organization, the level of teacher's satisfaction against their life conditions, and the goals´ and needs of their educators.

The Institutions of Superior Education have the purpose to develop professionals in the different areas of scientific knowledge. They form part of a community where authorities, professors and administrative employees interact in social, economical, political and normative environments. On this organizational context of the Institutions of Superior Education, quality of life represents a very important issue to generate a high quality level and an academic excellence.

Some discoveries: to investigate these issues has allowed to awaken the interest of the Educative Institutions´ authorities, so that they can promote a management culture and administrate their human talent with the aim to generate equal opportunities in their quality of life, to encourage productivity to higher levels, to excel their human resources and to preserve their intellectual resources with a better quality of employment life.

Business Intelligence & OLAP Tools:
Business Data Analysis

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Abstract

This paper describes the technological basis of Business Intelligence, a taxonomy of solutions, OLAP tools evolutions, and technology architecture. It discusses the business use, concepts, benefits and risks, standards, selection guidelines of OLAP tools. Finally, it explains the features of OLAP tools, the benefits for the enterprises, an introduction to multidimensional databases, and the terms ROLAP, MOLAP, HOLAP, desktop OLAP.

The Best Practices for a Good Corporate Government

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Abstract

The objective of this work consists of making an analysis of the best practices in the corporative government that are being adopted by the Mexican companies. It presents of the reaction of the companies in adopting the code of better practices along with the effect of this adoption. This work presents in the first place the normatividad established by the OECD for the determination of a good Corporative Government. It then shows the result of investigations that have found that the market of values awards a good Corporative Government.Finally, the paper presents the state of the Best Corporative Practices in Mexico. The main conclusion of this investigation is that the Mexican companies in their great majority (82%) have adopted the Code of Better Practices.

Environmental Education as a Process of Change in the Work Culture of Small and Médium Companies

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José Sánchez Gutiérrez
Universidad de Guadalajara, México

Abstract

The first World wide meeting about the environment convened by Union Nations (ONU) in 1972 in Sweden Stockholm was an important event. The companies and governments worldwide considered environmental problems and the damage to the ecosystems of our planet. Solutions were discussed to preserve our habitat. Most recently, these issues were discussed in a meeting held in Johannesburg, Africa in 2002. One element of strategy is environmental education.

Companies can approach environmental education at three levels - informal. non-formal and formal. This research incorporates several elements of philosophical, pedagogical and didactic types in the intervention of the formation and awareness of those who work in the Small and Medium companies. (PyMES) located in the Metropolitan Zone of Guadalajara (ZMG), with the enthusiasm to improve its environmental performance situation that is reflected in an Environmental Conscience Basic (CAB), without doubt will be important part of the present and future existence of these organizations.

Finally, a model of learning supported in the environmental education has been proposed that involves all the internal parties interested in the environmental problems. The model provides answers that can be used to create a new ecological culture in the organization.

A Tool for Elections: Political Marketing

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Abstract

Throughout the last 30 years, the electorate in Mexico has become much more conscience of the power of its vote. The participation percentage of the citizenship in the elections has increased remarkably since 1991 in Mexico. For this reason the political parties must take into account the demographic, psychological, geographic and the behavior characteristics of the citizens that will eventually vote. They must join the globalization process. The modernization methods of a complex world must be integrated to electoral process in developing countries. The application of techniques and their principles to communicate a political ideology and the candidate proposals, as well as the handling of the campaigns that are carried out in the electoral processes, is called political marketing.

Historic Evolution of Brazilian's Politics of Foreign Commerce

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Abstract

The Politics of Foreign Commerce in Brazil went through very special moments in the last 50 years mainly because of the prevailing conditions (in Brazil), which were characterized by little availability of high technology and non-existing industrial parks. The energy crisis of the 70's caused damage without precedents in all countries' economies, specially in Brazil. The country faced the "black decade", the 80's, and passed through some economic plans and changes of currencies but without much success.

Finally, after the commercial opening unchained by the Collor government in the 90's, the country initiated a fast paced process of industrialization. The change agent was the fall of the import taxes that compelled the industrial sector to leave its "comfort area" and to face the tough international competition. This caused the destruction of many companies, but the great majority of the ones that survived today enjoys a managerial and technological competence at the international level.

Sustainable Development and Economic Growth

Gabriela Correa
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Abstract

The discussion on the effects of the liberalization in the international trade on the environment is one of the areas in which the ideas and social values are over borders. It is not rare that international networks of ecologists participate intensely in local conflicts and be the forum that offer the networks of information.

On the other hand, the discussion on the relation among sustainable development and international trade has entered a notorious phase. International institutions such as the WTO, affirmed 10 years ago that the analysis of the consequences that the international trade had on the environment was not one of its responsibilities..