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Changing Role of Government in Services

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During most of the twentieth century, a major ideological, political, and economic debate has centered around the role of markets as opposed to that of governmental central planners. Socialists passionately believed that unfettered markets lead to exploitation of the masses, waste, and wrong consumption (Baran and Sweezy 1968). Western scholars saw the "invisible hand," as heralded by Adam Smith, as the best means to ensure not only efficiency but also freedom and democracy (e.g., Friedman 1962).

To be sure, very few economists believed that all transactions should be left to the market. It was clearly recognized that for efficient market operation there is a fundamental need to ensure the types of institutions, such as law and order to enforce contracts, that will allow these operations. Even Adam Smith saw a role, albeit a limited one, for the government.

Since the depression of the 1930s, there has been a clear trend of a constant rise in the size of government as a percent of the GNP as well as a great expansion of its duties. Calls for a Keynesian-type management of the economy and for a much more active role of government in spurring economic growth were coupled with the desire to help the poor, the aged, and the needy. All these forces led to a significant and growing increase in the share of government in the GNP and, therefore, an increase in taxes. Elsewhere I have shown (Aharoni 1981) that whatever the theoretical arguments for or against government intervention, much of the actual work of government redistributes wealth and mainly shields individuals and groups from risks. Individuals and

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firms lobby and apply pressure on the government to tilt resources so that their wealth will be augmented and the risks they face will be shared by the rest of society.

The rise of government cannot be measured only by its share in the GNP. Much more important is the increasing identification of more and more areas as requiring government intervention in the market, be it through regulation, through the ownership of state-owned enterprises, or through other means. Governments today have at their disposal a large variety of tools to manage demand and to influence supply. Governments can tax or exempt from tax, cajole, subsidize, finance, create infrastructure, protect, regulate, encourage innovation, use their procurement power to help certain firms, or create rents by limiting access to different fields. Governments use state guarantees, subsidized loans, different tax treatment, lenient surveillance of troubled situations, grants, allowances, direct subsidies, or subsidies of the major inputs. Governments provide aid to industry through the employment of a whole array of nontariff barriers (ingeniously manipulating licensing systems, safety regulations, and health requirements), training assistance, research facilities, advisory services, and intelligence gathering.

Governments can also institute measures to assure quality or use standards as barriers to foreign entry. They can decree that only their citizens be allowed to own certain firms or that only their ships can carry cargo. In short, a myriad of governmental laws, rules, regulations, and policies have a profound effect on the profitability and competitiveness of any specific business firm as well as the welfare of the individual citizen.

However, since the beginning of the 1980s there seems to have been an increasing disillusionment with the ability of the government to solve problems and a rising recognition of "government failures" (Wolf 1990). The small, isolated program of reducing governmental expenditures and privatization in Great Britain exploded into a global surge of "structural reforms." With the fall of the Berlin Wall in 1989, Western capitalism declared its victory and some scholars declared the "end of History" (Fukiama 1989). The high "cost of good intentions" (Morris 1980) was increasingly recognized, and more and more people pointed out the failures of liberal experiments and saw the welfare state as a major culprit, in reducing the competitiveness of some industrialized countries (Scott 1985). To be sure, this disillusionment is more powerful in Anglo-Saxon countries than in other countries that have developed social market economies (Albert 1993).

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Another clear trend in the 1980s has been the increasing globalization of markets. Whether the world is really as global as Levitt (1983) posited and society as borderless as claimed by Omahe (1990), clearly different countries are much more interdependent, and governments often find themselves impotent in fighting global trends. Sylvia Ostry (1992) has pointed out that globalization is dominated by flows of technology and investments. Globalization, in turn, creates growing pressure for convergence of policies, and that causes international frictions.

A third trend has been the move of the societies into service economies. In both developed and developing countries the service sector has become the largest of the three economic sectors, comprising more than three-quarters of GNP in the industrialized countries. In addition, world trade in services has been growing at a faster rate than world trade in goods. Finally, more and more service sectors, from the media to airlines to financial services as well as auditing, appear to be increasingly dominated by a few global megaservice enterprises. Understanding the firm-specific advantages of such firms is of utmost importance when analyzing their role.

To understand the role of government in an interdependent economy, heavily dominated by global service Multinational Enterprises (MNEs), it is necessary to be clear about several factors and their interaction. First, what are the reasons and the consequences of globalization of different service industries? Are the reasons and the consequences the same or different in different industries? Second, what are the reasons for the changing role of government and what can one reasonably expect a government to achieve? Once these two points are clear, they can be combined to answer the question, what is the optimal role of government that will allow countries to gain maximum benefits from the increasing globalization of the service industries? To be sure, the optimal role of the government may be found to be different in advanced nations and in countries whose economies lag behind those of the richest. Clearly, however, in an era of global corporations with very little nationality and in an era when borders are ceasing to exist, the role of government is changing.

This chapter is an introduction on the role one can expect governments to play and the means to be used. Clearly, questions about the role of the government are not the same as those about the size of government, and both have materially changed as a result of increasing globalization. Whether aspiring for smaller government and less taxation or not, one must recognize that markets do not operate unless

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certain institutions exist and that, since government must govern, the imperative question is how to ensure that its operations and decisions will be as efficient as possible. Further, many of the globalized services—from banks to telecommunications to airlines—will operate in oligopolistic if not monopolistic markets (Mahini and Turek 1993). This means that governments, in particular those of small nations, will face the major dilemma of reconciling the need for cultural uniqueness with the demand to participate in the global economy. Further, participation in the global economy may mean that certain services will be supplied by foreign-owned and -controlled MNEs. Whether they are "us" or "them" (Reich 1991), governments representing their citizens might wish to find some means to secure the supply of these services. Small countries may also be hard pressed to ensure adequate supplies in a global era. Questions such as security of supply are scarcely discussed in economics, but in fact such questions are of greater importance in services than in goods, since solutions such as stockpiling are not available.

This chapter starts by analyzing some of the major differences in ideological beliefs and assumptions among those abhorring governments' active role and those advocating such a role. Section I briefly surveys the normative economic theories on the role of government. Section II adds noneconomic considerations, Section III discusses government failures, and Section IV analyzes the impact of globalization on governments.

MARKETS, PLANNING, AND GOVERNMENT: NORMATIVE ECONOMIC THEORY CONSIDERATIONS OF THE ROLE OF GOVERNMENT

The debate among various scholars on the relative roles of markets and governments is a very old one. It is largely based on ideology and values, not on economic logic. Unfortunately, current economic theory does not provide a coherent normative (or even positive) framework to allow one to decide when and how a government should intervene in the operations of the market. The basic tenet of the classical economic theory is that unfettered markets are best in achieving resource allocation. The theory is quiet about the distribution impact of such resource allocation. In fact, even when the social side is ignored, and on pure efficiency grounds, the theory is quite ambiguous.

Most economic analyses of government intervention in the market make the implicit assumption that markets are self-perpetuating and

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freestanding. Left without any intervention, the market mechanism will automatically result in the most efficient and harmonious results. It efficiently coordinates millions of individual choices and transactions. Therefore, the economist's justification of government intervention has rested traditionally on market failure. When the market fails in its allocative role—for example, because of increasing returns to scales that would lead to a national monopoly situation—the government can decide to regulate the private firms or to own them.

First and foremost, a government is needed to maintain law and order and protect property, since greedy individuals may decide that theft is a better way to gain wealth than exchange. In fact, a market exchange system presupposes peace, moral behavior, and the enforcement of law and order. Moreover, markets are not automatically created. To have transactions in a market, many institutions are needed and uncertainty must be reduced. Government's first role is to ensure the legal, organizational, and institutional capacities that will allow markets to operate.

On efficiency grounds, again, government is said to have to intervene only in cases of demonstrable market failure. Yet many of the contributions to economic theory in the last few decades have shown a long list of market failures. The economics of information and incomplete markets have demonstrated a myriad of cases of market failure. In fact, Greenwald and Stiglitz (1986) have convincingly demonstrated that whenever information is imperfect, Pareto efficient allocation of resources cannot be attained. In other words, markets are almost always inefficient. As Frank Hahn (1991, 47) has argued, if Pareto efficiency requires perfect information then Pareto efficiency is not Pareto efficient! If government intervention is justified by market failure, it follows that government should intervene in almost every aspect of life! Since such a pervasive role of government is unpalatable for many economists, they started looking for cases in which market failures are "large enough." To many economists, the essential economic functions of government, in addition to the provision of law and order, are:

1. to provide physical infrastructure, especially that which has high fixed costs in relation to variable costs, such as harbors, railways, irrigation canals, and sewers;
2. to maintain macroeconomic stability;
3. to supply "public goods" including defense and national security, education, basic research, market information, the legal system, and environmental protection;

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4. to contribute to the development of institutions for improving the market for labor, finance, technology, etc.;

5. to offset or eliminate price distortions which arise in cases of demonstrable market failure; and

6. to redistribute income to the poorest in sufficient measure for them to meet basic needs.

Another way of looking at the problem is to pose the question, when will government intervention have advantage over markets, and when are markets preferred, even if they are imperfect? Stiglitz (1989) pointed out that governments do not have more information than private actors. The advantage of the government stems from its monopolistic ability to exert legal and taxing power. By using its power to tax, the government can alter the economic appeal of different activities—making some more attractive by reduced taxes or subsidies financed by taxes and making others less attractive by higher taxes. The government can also use its power by issuing regulations, such as banning smoking on certain flights. Thus, when moral hazard problems hamper a private insurance firm, a government may be able to change behavior by taxing inflammable materials or subsidizing fire extinguishers or by simply prohibiting the use of certain materials. The use of taxing, proscribing, and punishing power of the government may allow it to correct the problem of moral hazard or to internalize externalities. It is more difficult for government to solve market failures stemming from lack of information.

Finally, many economic theories assume that the costs of deciding what to do and carrying out these decisions is zero. In other words, transaction costs are ignored. Yet, without transaction costs firms would not exist. The irony of basing a theory on the demonstrated market failure is that modern MNE theory has demonstrated that the existence of MNEs can be explained only if one assumes market failure! Internalizing theory, starting with the seminal contribution of Coase (1937), explained the operation of the firm as stemming from market failure, where hierarchy is a better, more efficient mode of operation than free-market exchanges.

In the real world, a major problem is that of lack of knowledge and the need to generate and use knowledge. When knowledge is incomplete, people may be surprised. To take into account uncertainty, people build reserves—of cash, of medicines, or of fire extinguishers. Further, people do not face a closed set of alternatives among which

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resources are to be allocated. They must look for new and innovative ideas, and government might have a major role in helping to generate knowledge (Loasby 1991), creating capacities to learn and enhancing capabilities.

THE SOCIAL, POLITICAL, AND MORAL DIMENSION

Even if one assumes that we know the economic answer, the role of government is clearly based not only on economic reasoning but also on social, political (who gains), cultural, and moral considerations, as well as that of better management.

Socialists were convinced that the legal status of property is a crucial determinant of the use of that property. Capitalism for them meant a dance around the golden calf—oppression of workers and a wrong distribution of wealth and power. State ownership was seen as ideal despite strong hostility to the state as an employer. The state was deemed as representing the community, not as a political power. Democratic control over the means of production was expected to create more efficiency and economic growth. It was believed to create a just economic system and an ideal society based on cooperation, equality, and mutual collaboration. It was also believed to eliminate worker alienation, create harmonious relations, emancipate oppressed groups, and liberate frustrated energies. Socialists believed—naively as it turned out—that one needs simply to transfer the ownership and control of wealth-producing assets from the private to the public sector to revolutionize industrial societies, placing the workers in a new position of trust, responsibility, and involvement, reducing the costs to the consumer and creating equality among individuals. The expectation that state ownership would wipe out all problems perceived to be created by the greedy capitalist system was certainly exaggerated.

Many would justify government intervention on moral grounds. The market system, some vigorously claim, is ethically wrong. It creates limits that are socially intolerable because the costs under the system are borne by those least able to bear them: "Abolition of luxury and waste, or obviously harmful forms of expenditure on education, health, public transport, conservation of natural resources, etc." (Mandel 1968, 2:616). Advertising increases waste and encourages materialistic values. Government intervention therefore is needed to increase production of "socially desirable" goods and services. The production of wealth, according to this view, cannot be based on economic criteria

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alone, but must take social, ethical, and political considerations into account as well.

Capitalism, when left to the discipline of the marketplace and the "invisible hand," has been found to be too harsh and heartless. The suffering during depressions and the inhuman conditions of work in British nineteenth-century factories have been considered too high a price to be paid for an unfettered operation of the market. With the increased interdependence of the world, these problems have grown too, and their magnitude is such that few people today believe in complete laissez faire. It is widely recognized that government's involvement in the economy is sometimes indispensable to avoid a vast wreck, alleviate extreme social injustices, and avert calamities, including rapid exhaustion of resources.

"Economic adjustment" cannot be achieved in a laboratory. It involves human beings: people who are unemployed because their skills are no longer needed, people who are uprooted from the village or town of their ancestors and moved to cities to join the anonymous masses, people who have to learn a new profession at an advanced age, people who must begin life over again at a time when they would have liked to begin enjoying the fruits of their earlier labors. But people who find themselves in predicaments such as these are no longer entirely powerless; they are also voters. When they rebel against bearing the costs, governments are often forced—and sometimes choose—to arrest economic progress by subsidizing an obsolete industry, preserving the status quo, and avoiding too rapid a change.

Conservatives deplore any government presence in economic affairs. They also do not believe government can achieve efficient results. Largely because of their discontent with any government intervention in the assumed frictionless operations of the market, they view governments as cold bureaucracies with rigid rules and misguided fixation on the wrong issues. For them, government interference only prevents the free flow of goods, services, and incentives. They see any government operation as meddling, causing waste, extravagance, and proliferation of bureaucracy. To the extent that government intervention is accepted, if it is focused almost exclusively on the role of the government in the regulation of markets in order to prevent any interfirm cooperation, such cooperation is viewed as wrong.

The world has become much more interdependent while, at the same time, citizens of each country would like to be shielded from many changes. While governments recognize the need to be a part of a global system, each of them attempts to tilt the benefits to their citizens

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and to maintain cultural heritage. In services, where no inventory or stockpiling for emergency is possible, the need to maintain some minimum sovereignity over the supply of telecommunications or transportation services may reduce the willingness of governments to allow free reign of global markets.

For many political scientists, in particular in the United States, the political public arena is simply a battle ground for all sorts of interest groups, each one of which vies for its share from the public purse. As they see it, a more general national public interest cannot be defined. The political arena is simply a place in which powerful interest groups or economic actors use their power or political clout to influence that type of government intervention in the market that will maximize or at least increase their profits. Stigler (1971) indeed argued that the regulatory policies of the government are captured and serve the interest of the powerful regulated. Others claim that the firms are seeking rents (Tullock 1967; Krueger 1974; Posner 1975; Buchanan, Tollison and Tullock 1980).

Ideology, claims Feigenbaum (1985), "is in a sense the secret weapon of the private sector in keeping the state at bay, or at least in minimizing state incursions . . . the ideological sinews . . . inhibit [the state] from solving the problems of advanced capitalism." Neither the private sector nor the state capitalist sector seems to have an incentive structure that promises an easy solution to the problems of industry reindustrialization and inflation. Strong states, Feigenbaum argues, become weak states because they are captured by managers and by the idealization of the market.

One might say that economic markets are obviously not allowed to operate free of political purposes and that economic outcomes have an impact, sometimes a heavy one, on social and political events (Thurow 1983, 226). Not least important in evaluating the role of government is the public judgment of the legitimacy of its role. Alan Lewis (1982) has compiled an impressive list of evidence on a close association between the sense that taxes are fairly imposed and the purposes for which revenues are being used are legitimate and the extent of tax evasion. An analysis of government policy that ignores legitimacy and relies solely on pecuniary incentive is incomplete.

More generally, the degree of success of governmental action depends on the ability of government leaders to achieve a high degree of cooperation among different segments of the population. A government must act as a consensus builder among various interest groups in attempting to achieve a national goal. Its ability to do so is the most

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important variable in explaining the success of some countries and the dismal failure of others in managing the economy by government actions. The variables leading to the achievement of success are social and political more than they are economic, at least as economics is defined by its staunch neoclassical proponents. They include a sense of obligation to the community, role models, some degree of altruism, involvement and participation, social pressures, group norms, and the public judgment of the legitimacy of the role of government. These variables should be part and parcel of a theory of public choice.

Markets are a human artifact, created by laws and institutions. The role of the market is defined by human beings and is different in different societies. A market economy only creates market values. Justice, sympathy, love, honesty, or social companionship are not produced by the market. These extra-market values are of great importance. Further, the market system is based on peace. It does not take into account the need to defend one's rights, territories, or property. Yet theft, fraud, or extortion are illegitimate and certain goods are kept out of the market for moral reasons. Most countries do not allow markets in sex, babies, drugs, blood, or votes. Further, there are significant differences between the Anglo-Saxon free market and the Germanic social market (de Jong 1993). In the latter, firms have obligations toward many stakeholders and government has a mediating and coordinating role. Albert (1993) differentiates between nonnegotiable goods, mixed goods, and negotiable goods. Negotiable goods are subject only to the rule of markets. Mixed and nonnegotiable goods are not. Whether or not a good belongs only to the market economy is to a large extent a function of culture. Thus, housing in the United States is almost exclusively a market commodity, but not so in Germany. Similarly, the media, companies and wages, and urban transportation are seen in the United States as only subject to market operations, while in other countries they are not. Wages, for example, may be based on seniority or nationally agreed pay scales. Labor may be perceived as sharing social responsibilities, not only as a hired production factor.

In most cases, the desires and needs of some individuals come into conflict with what other individuals regard as immoral. The right of an individual to do as he or she pleases is restricted not only by the right of other individuals but also by their moral indignation. If indignation is sufficiently strong, laws are passed that forbid certain private exchanges on moral grounds. Sometimes an illegal market is created. Prostitution and gambling continue even though they are illegal, and blood is sold even where forbidden by law. Attempts to eliminate

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other immoral behaviors simply continue on the grounds that they should not be condoned. No one suggests, for example, that murder should be legalized on the grounds that the police fail to catch all murderers.

It is undeniable that market allocation is flexible, adaptive, and efficient and that it dispenses with the need for bureaucracy. It is also clear, however, that some decisions should not be left to the vagaries of the market. Thus, the market is not the most efficient mechanism in making decisions regarding national goals, or in priorities on such irreversible decisions as saving for a pension. In all these cases, the nation may have different mechanisms and constraints for making the decision.

Further, as the late French economist François Perroux once wrote:

> For any capitalist society to function smoothly, there must be certain social factors which are free of the profit motive, or at least of the quest for maximum profits. When monetary gain becomes uppermost in the minds of civil servants, soldiers, judges, priests, artists or scientists, the result is social dislocation and a real threat to any form of economic organization. The highest values, the noblest human assets—honor, joy, affection, mutual respect—must not be given a price tag; to do so is to undermine the foundations of the social grouping. There is always a more or less durable framework of preexisting moral values within which a capitalist economy operates, values which may be quite alien to capitalism itself. But as the economy expands, its very success threatens this framework; capitalist values replace all others in the public esteem, and the preference for comfort and material well being begins to erode the traditional institutions and mental patterns which are the basis of the social order. In a word, capitalism corrupts and corrodes. It uses up society's vital lifeblood, yet is unable to replenish it. (*Le Capitalisme*, in the "Que sais-je?" series, 1962; quoted in Albert 1993, 106)

GOVERNMENT FAILURE

A generally held (at least implicitly) assumption during the 1950s and the 1960s was that governments act solely in the pursuit of the public interest to correct market failure. Given such an implicit assumption, it was relatively easy to be persuaded that a given problem must be solved by governmental action and that governments—politicians, bureaucrats, and public enterprise managers—are all exclusively directed by the desire to maximize social goals. Both theoretical

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developments and practical experience, however, demonstrated that governments suffer from their own sets of failure (Wolf 1990). Government bureaucrats, politicians, and managers were shown to be selfish and looking out for their own interests rather than those of the public (Niskanen 1971).

This "bureaucratic capture"—taking care of the interests of those employed in a government department rather than serving the public interest—was demonstrated in many works. A different stream of theoretical works has shown that government regulators are very often "captured" by those to be regulated (Stigler 1971) and serve the interests of firms they are supposed to regulate. It was also shown that the existence of constraints on market operations creates many opportunities for "rents" to those who receive licenses or any other form of government protected goods. "Rent-seeking behavior" (Krueger 1974) is becoming common. Business persons may find that looking for political patronage is much more lucrative than developing markets.

One result is that resources are devoted to lobby and other interest group activities and these pressure groups control much of the policy process. Some would even argue that in a democracy governments cannot be impervious to this kind of rent-seeking behavior—or plea for special favors. Politicians want to be reelected and therefore will not dare to antagonize strong interest groups or retract (or even reduce) the rents granted to these groups in the past.

Thus, when the discipline imposed by the market mechanism is lost, for whatever laudable reason, limits must be set by some other mechanism. Governments can shift the burden of risk from certain individuals to others or else divide the risk among many. Nevertheless, the insurance premium must be paid. At the same time, each individual feels entitled to more guarantees, more income, and the supply of more services. The individual does not have to decide who will pay. Therefore, the demand for government-supplied services increases and, often, the budgetary deficit of the country as well. Each government is increasingly hemmed in by decisions made by previous governments and tends to postpone unpopular decisions as much as it dares, often until it is too late.

For the radical economist, the institutions of capitalism, private property, and markets are socially wrong and economically full of irrepressible internal contradictions. Gross inequality of wealth, poverty, and radical inequality are all caused by the greed of big business controlling the political machinery. Even if one assumes that big business controls the country, this by itself is hardly a reason for advocating

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more public planning and governmental involvement since, in this case, big business presumably controls the government too.

"Government failure" could also stem from lack of incentives to do better. Managers of state-owned enterprises have lost large sums of money without being fired or replaced. When it is extremely difficult to measure performance, as in many government supplied services, it is clearly not very easy to tie remuneration to performance. The result may be reduced incentives and lack of management ability. If government does not know how to manage, it creates more harm than good. In many cases, when one identified government failure, the problem was moved to another government: from the federal to the state level in the United States or from local to central government in Great Britain. Moreover, little correlation exists between the degree of government intervention and industrial policies on the one hand and economic growth or any other measure of economic success on the other. Much depends on the way the system is managed.

To some economists, the selfish behavior of bureaucrats, the capture of the regulators, and the rent-seeking behavior resulting from possible manna stemming from governmental intervention are powerful reasons to call for elimination of any government intervention. Such calls, however, are often based on ideology rather than pure economic logic. Indeed, these views are heralded mainly by American economists (for one of many recent examples, see Bailey 1993). Other economists, including some in the United States, believe government responsibilities lead inexorably to expanded roles, including those of devising and carrying out industrial policies and creating new markets.

All in all, a major difference among various theories is the implicit assumptions made on the nature of the government. For the believer in industrial policies, government is wise and benevolent and works singlemindedly to achieve national goals. To those preaching problems in government and calling for deregulation, government policies are based on self-interests of many diverse interest groups, and the national interest becomes totally undefined and unreachable. In banking, many countries have regarded financial stability as more important than competitive efficiency, and the Savings-and-Loan turmoil in the United States has convinced many that governments should seek stability, not deregulation. In many service industries, such as transportation and telecommunication, governments have faced a choice between competition that leads to services being offered only in the more profitable markets and the need for universal coverage. Governments sometimes regulated to redistribute rents from some classes of customers to others.

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These and other regulations were possible when markets were confined to national borders and regulations could impose and enforce geographical limitations. The globalization of the markets has changed much of this.

GLOBALIZATION

The world economy is now influenced by the inexorable dynamism of technology. Economic growth, the population explosion, increasing affluence, easier communication, and faster transportation all converged to generate increased demands for goods and services around the world, and technological developments vastly increased the speed and reduced the costs of transferring goods and services across national borders. Governments of several nations have made a concerted effort to help national champion firms specialize in the production of certain goods and trade these goods internationally, only to find that despite huge sums spent on subsidies, these firms could rarely compete against the more efficient, global enterprises when the border opened. The theory in these fields has not been able to keep up with these developments.

Technological advances are one source of growing interdependence; another is the acceleration in the growth of international trade and international production encouraged by the first. International travel makes people in one country much more aware of the customs, cultures, and habits of others, an awareness that movies and television reinforce.

These and other developments increased the volume of international trade but also caused many firms to go abroad for international sourcing or to secure overseas marketing by undertaking business operations outside their country. Multinational companies increased their investments and turned from working in different distinct national markets to becoming global in scope of operations. The government's role has intensified as questions of trade policy have been the subject of a bitter debate among different countries, arguing for a different distribution of the gains from trade. The economic well-being of many nations has become more and more dependent on outside forces.

Immediately after World War II, international interdependence was actively encouraged by governments through such policies as the convertibility of currencies, voluntarily reduced tariffs, and sometimes the increase of mobility of capital and labor across national borders. Although totally free movement of all factors of production and trade

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has never been allowed, attempts to increase freedom and integration have been made. International bodies have been created to avoid a repetition of the devastating beggar-thy-neighbor policies adopted by many countries between the wars.

But, though it increases the wealth of nations, interdependence also limits the freedom of each government by embedding each country in a matrix of constraints which it can influence only slightly, often only directly, and without certainty of effects (Cooper 1968, 4). As a result, each nation has become vulnerable to forces in the international arena and to the impact of the economic and social actions of other countries. Policies designed to achieve results in the domestic economy that do not take into account the policies of other nations are doomed to failure or to only partial success. Spillover effects from other economies can result from changes in interest rates, prices, costs, income, and government tax policies, any one of which rapidly affects the local factors of production. The greater the interdependence, the smaller the amount of discretion left to any one government. The world economy has thus become a fragile and interconnected system. In an open economy, it is impossible to conduct an autonomous national economic policy. Countries are far from being watertight compartments. Unless they opt to revert to trade restrictions and capital controls, they cannot ignore external conditions and constraints. Moreover, with the sole exception of the United States, no country can afford to increase the public debt significantly in order to offer more incentives to the private sector.

Governments also had ample opportunity to learn that their policies must pay close attention to external constraints. In the increasingly seamless financial market environment, governments are confronted with speculative attacks on their currencies when the speculators believe the policies to be inconsistent. Maintaining confidence of a global private sector is thus an important component of government policies.

Caught in the bind between interdependence and the promise to maintain full employment and social protection, many governments have felt that Keynesian aggregate demand policies have become insufficient in achieving their contradictory national aims. One country after another has searched for specific modes of intervention, hoping to find some method that would allow them to achieve both goals. The government's ability to lead the nation and any hope it has of creating a coherent public policy that allows growth are said by many to depend on policies designed to develop specific industries by industrial policies of focusing and targeting. It has often been suggested (e.g.,

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Johnson 1982, 19) that governments can change factor endowments and create comparative advantages that allow firms to win the competitive game in an infant industry. Persistent government efforts to nurture a specific industry, and not the automatic resource allocation in a frictionless market, are advocated as a means to trigger development of growth industries.

To the believer in industrial policies, government intervention as practiced by Japan or South Korea is the best means to achieve growth and prosperity. To be sure, some scholars, notably Patrick and Rosovsky (1976), ascribe the high growth rates of Japan to much more mundane factors. They argue that a well-educated labor force, high rates of investment made possible by high savings, and the rapid introduction of technology have fueled Japan's high growth rates (1976, 15). As they analyze the situation, the main impetus to growth has been private-business investment demand, private saving, and industrious and skilled labor operating in a market-oriented environment (1976, 47). Many others, however, emphasize the role of a stable, active government, working closely with private business to channel resources into strategic industries (see, e.g., Johnson 1982; Anchordoguy 1988).

The notably close relationships between private firms and government in Japan are not unique. In all industrialized market economies, the government has designed elaborate methods for aiding private industries. Facing recession and unemployment, countries have been emasculating liberal trade agreements through all kinds of invisible methods. These methods range from acquiring the firm outright, to covering its losses through general taxation revenues, to using guaranteed government procurement to favor local manufacturers by paying them higher prices for products supplied to government.

There is, however, a clear difference between intents of those proposing industrial policies and the reality of explicit industry-specific interventions targeted at improving performance of specific industries. In many cases, industrial policies were dispensed to aid "sunset industries" rather than to pick new winners.

Demands for protection are as understandable as the response to them of popularly elected governments who must face the voter. As long as people believed that governments could not tilt, change, or otherwise alter economic phenomena—as long as unemployment, for example, was conceived of as an unavoidable calamity—people did not expect the government to protect them from such events. Advances in science encourage the belief that cures can be found for all

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ills and that governments ought to supply the cure. If the solutions shift the burden to foreigners, all the better. After all, national governments are elected by a domestic, not international, citizenry; their responsibilities at home overshadow their responsibilities to the outside.

The use of subsidies for encouraging production, employment, and investment, the design of government procurement policies to create a protective umbrella for local industry, and mounting requirements for tie-in arrangements in foreign aid are all mechanisms that have become much more sophisticated and selective and are designed to help an industry here, prod a firm there, or help a region somewhere else. Firms often present their problems as abnormal, temporary, or caused by the noneconomic behavior of foreign firms. Economic experts warn that the problems are structural rather than abnormal, and chronic rather than temporary, but governments still go by their political instincts as much as by economic arguments. They step carefully to save votes. As a result, there is a trend toward more dependence of firms on government to reduce the risk of competition.

In theory, social mobility and technological change mean that new forces are allowed to come in and that business firms that do not adapt to the new conditions disappear. If, however, the state is defending and protecting the status quo, no change is allowed. Yet the advent of the global economy significantly reduces the power of the government to protect inefficient domestic firms. Indeed, the advent of the global economy, the growth of cross-border transactions, and the increasing salience of global enterprises mean that governments will face many new challenges. Globalization basically means that many services (and goods) will be supplied by large, global firms that will determine the location of production on the basis of their own welfare, thus shifting location as changes in prices of factors of production and governmental policies change the costs and revenues of the MNEs (or of the large store, sourcing from abroad; see Gereffi 1994).

Clearly, a major characteristic of a global economy is the ability to rapidly shift production from one location to another. To be able to compete, firms seek the cheapest combination of factors of production. Some of these are intangible assets, such as goodwill, trade marks, brand names, reputation, know-how and the ability to transfer this know-how to other individuals and firms. Some are more tangible assets—both financial and physical assets. Intangible assets are often traded within the firm or within a network of known suppliers. Tangible assets are looked for wherever they may be found to be cheaper in use. Often the expenses of use also include the level of uncertainty

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caused by the domestic government's behavior and the ability to spread the risks through insurance. Governments that decide to protect their firms from global competition create by these anticompetitive strategies a structural market failure (Dunning 1993). They also reduce the ability of other firms to be competitive in the world arena. By the same token, governments that do not create the conditions to allow global firms to operate in an efficient way may help increase what Dunning terms "endemic market failures." Both of these market failures result in increasing transaction costs and raise the prices of services or goods exchanged above the opportunity costs of resources used. At the same time, firms need by sheer necessity to globalize the sourcing of their inputs and, in many cases, the sale of their outputs.

In service industries, where economic activities are largely based on created, intangible assets, much of the trade is done among similar countries (in terms of their wealth), and the nature of the competition has shifted from firms in the same country to firms in different countries vying for world market share. In this global competition, governments play a decisive role, and their decisions may impact the decisions of the MNEs with regard to the location of their different activities. The government can influence the MNE by its taxation policies, regulation, procurement policies, and so on. As one example, the MNE searches for the cheapest source of capital. Government policies affect the cost of obtaining capital in any specific nation state. The costs to the MNE are not only a result of known prices, but also the degree to which the system works smoothly. Delays in transportation, difficulties in sending faxes or getting a phone line, difficulty in negotiations across cultures, all shape the cost function as do governmental regulations and taxes.

Cultural considerations may also be important, as when a government attempts to protect its television or movie industry to preserve cultural heritage. No less important is the problem of ensuring adequate supply of the services. In a world of egoists, what is to guarantee a country that a global firm will continue to supply it with all the needed services? Unless government regulates to ensure continuous and uninterrupted services, even when such service supply may be uneconomical, the service may not be available. This is true in terms of transportation to some remote villages and not less so for the continuation of services in case of war. It may be highly unlikely that in a case of war or when a major power applies sanctions against a country, MNEs will stop insuring the assets in that country. It is much easier to imagine that airlines will cease flying to that nation. In fact, during

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several wars in the Middle East, foreign airlines stopped flying or, in other cases, charged exorbitant, additional costs to cover insurance on flights to Israel. As recently as 1991, many international airlines suspended their flights to Ben Gurion airport, and El-Al, the small Israeli-owned airline operating from bankruptcy, supplied the only flights in and out of the country. Thus, countries may fully benefit from participating in the global economy by following the specializing of markets, but such specialization may wreak havoc in the economy if supply is suspended. In the case of natural resources, countries may decide to stockpile as a relatively simple safeguard. Services, however, cannot be stockpiled. Having an airline service twice a day does not allow one to fly the next day, if no flights are offered.

CONCLUSION

If the economy is assumed to be self-regulating, then the government is distorting the free, self-regulating flow of goods and services. At the same time, the government may have an important role in avoiding the destruction of the system. As an ultimate arbiter of conflicts assumed to be endemic to the system, the government must maintain not only law and order but must also preserve the social fabric.

The role of the government has become much more complicated because government must facilitate operations and direct its activities to help firms achieve greater competitiveness. The major question in a globally interdependent world is not how much government but what kind of government, achieving which goals. The globalization of services adds some questions concerning the government's role that must be fully understood.

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