CHAPTER 8

Government Intervention in International Business

International Business: The New Realities

by

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Learning Objectives

1. The nature of government intervention
2. Rationale for government intervention
3. Instruments of government intervention
4. Consequences of government intervention
5. Evolution of government intervention
6. Intervention and the global financial crisis
7. How firms can respond to government intervention

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Government Intervention

- Governments intervene in trade and investment to achieve political, social, or economic objectives.
- Governments impose trade and investment barriers that benefit interest groups, such as domestic firms, industries, and labor unions.
- Government intervention alters the competitive landscape, by hindering or helping the ability of firms to compete internationally.
- Government intervention is an important dimension of *country risk*.

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Government Intervention

- **Protectionism** — national economic policies that restrict free trade. Usually intended to raise revenue or protect domestic industries from foreign competition.
- **Customs** — the checkpoint at national ports of entry where officials inspect imported goods and levy tariffs.

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Government Intervention: Key Instruments

- **Tariff** – a tax on imports (e.g., citrus, textiles)
- **Nontariff trade barrier** – government policy, regulation, or procedure that impedes trade
- **Quota** – quantitative restriction on imports of a specific product (e.g., imports of Japanese cars)
- **Investment barriers** – rules or laws that hinder foreign direct investment (e.g., Mexico's restrictions in its oil industry)

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Example of Protectionism: U.S. Steel Industry

- The Bush administration imposed tariffs on imports of foreign steel to protect U.S. steel manufacturers from foreign competition, aiming to give the U.S. steel industry time to restructure and revive itself.

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Example of Protectionism: U.S. Steel Industry

- The Bush administration imposed tariffs on imports of foreign steel to protect U.S. steel manufacturers from foreign competition, aiming to give the U.S. steel industry time to restructure and revive itself.
- However. It resulted in:
  - higher steel costs;
  - increased production costs for firms that use steel, such as Ford, Whirlpool and General Electric
  - reduced prospects for selling products in world markets, making U.S. steel firms less competitive.
- The steel tariffs were removed within two years.

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Example of Protectionism: Auto Industry

- In the 1980s, the U.S. government imposed ‘voluntary’ export restraints (quotas) on imports of cars from Japan, to insulate the U.S. auto industry from foreign competition.
  - Result 1: Detroit automakers had less of an incentive to improve quality, design, and overall product appeal.
  - Result 2: Detroit’s ability to compete in the global auto industry weakened.

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Consequences of Protectionism

- Reduced supply of goods to buyers
- Price inflation
- Reduced variety, fewer choices available to buyers
- Reduced industrial competitiveness
- Various adverse unintended consequences (e.g., while the home country dithers, other countries can race ahead)

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General Rationale for Government Intervention

- Tariffs can generate substantial *government revenue*. This is a key rationale for protectionism in undeveloped economies.
- Helps ensure the *safety, security, and welfare of citizens*. E.g., most countries have basic regulations to protect the national food supply.
- Helps the government pursue broad economic, political, and social objectives for the nation.
- Can serve the interests of the nation's firms and industries.

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Defensive Rationale for Government Intervention

- **Protection of the national economy** – weak or young economies sometimes need protection from foreign competitors. E.g., India imposed barriers to shield its huge agricultural sector, which employs millions.
- **Protection of an infant industry** – a young industry may need protection, to give it a chance to grow and succeed. E.g., Japan long protected its car industry.
- **National security** – the United States prohibits exports of plutonium and similar products to North Korea.
- **National culture and identity** – Canada restricts foreign investment in its movie and TV industries

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Protecting national culture and identity

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Offensive Rationale for Government Intervention

- **National strategic priorities** – protection helps ensure the development of industries that bolster the nation's economy. Countries create better jobs and higher tax revenues when they support high value-adding industries, such as IT, automotive, pharmaceuticals, or financial services.
- **Increase employment** – protection helps preserve domestic jobs, at least in the short term. However, protected industries become less competitive over time, especially in global markets, leading to job loss in the long run.

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Types and Effects of Government Intervention

Intervention Type	Definition	Practical Effect on Customers, Firms, or Government	Contemporary Examples
Tariff	Tax imposed on imported products.	Increases cost to the importer, exporter, and usually the buyer of the product. Discourages imports of products. Generates government revenue.	Switzerland charges a tariff of 44% on agricultural product imports. Cote d'Ivoire charges a tariff on most finished products.
Quota	Quantitative restriction on imports of a product during a specified period of time.	Benefits early importers, giving them monopoly power and the ability to charge higher prices. Harms late importers, who may be unable to obtain desired products. Usually results in higher prices to the buyer.	Brazil has imposed a quota on the number of foreign films that can be imported for theatrical screening and home video distribution.
Local content requirements	Requirement that a manufacturer include a minimum percentage of added value that is derived from local sources.	Discourages imports of raw materials, parts, components, and supplies, thereby reducing sourcing options available to manufacturers. May result in higher costs and lower product quality for importers and buyers.	The Nigerian government requires that products and services used by foreign firms in the oil industry in Nigeria must contain over 50% Nigerian content.

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Government Intervention Types and Effects (cont'd)

Intervention Type	Definition	Practical Effect on Customers, Firms, or Government	Contemporary Examples
Regulations and technical standards	Safety, health, or technical regulations; labeling requirements.	May delay or block the entry of imported products; and reduce the quantity of available products, resulting in higher costs to importers and buyers.	Saudi Arabia bans importation of firearms and used clothing. The European Union requires extensive testing on thousands of different imported chemicals.
Administrative and bureaucratic procedures	Complex procedures or requirements imposed on importers or foreign investors that hinder their trade or investment activities.	Slows the import of products or services. Hinders or delays firms' investment activities.	Russia imposes a series of inspections and bureaucratic procedures for the import of alcoholic beverages.
FDI and ownership restrictions	Rules that limit the ability of foreign firms to invest in certain industries or acquire local firms.	Reduces the amount of money that a foreigner can invest in a country, and/or the proportion of ownership that a foreigner can hold in an existing or new firm in the country. May require a foreign firm to invest in the country in order to do business there.	Switzerland requires foreign firms seeking to sell insurance there to do so by establishing a local subsidiary or branch office, via FDI. Brazil restricts foreign investment in its media industry and certain transportation industries.

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Government Intervention Types and Effects (cont'd)

Intervention Type	Definition	Practical Effect on Customers, Firms, or Government	Contemporary Examples
Subsidy	Financing or other resources that a government grants to a firm or group of firms, intended to ensure their survival or success.	Increases the competitive advantage of the grantee, while diminishing the competitive advantages of those that do not receive the subsidy.	Turkey grants an export subsidy of up to 20% for local producers of wheat and sugar.
Countervailing duty	Increased duties imposed on products imported into a country to offset subsidies given to producers or exporters in the exporting country.	Reduces or eliminates the competitive advantages provided by subsidies.	India imposes countervailing duties on the import of numerous products.
Antidumping duty	Tax charged on an imported product whose price is below usual prices in the local market or below the cost of making the product	Reduces or eliminates the competitive advantage of imported products priced at abnormally low levels.	The United States has imposed antidumping duties on the import of low-cost steel, in order to support U.S.-based steel manufac-turers.

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Sampling of Import Tariffs

	Average Import Tariff	
Country/Region	*Agricultural Products*	*Nonagricultural Products*
Australia	2.8	5.6
Canada	10.8	2.9
China	16.0	9.1
European Union	11.8	2.4
India	41.9	5.5
Japan	10.1	1.3
Mexico	39.8	9.1
United States	5.3	2.0

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Average Tariff Rates Over Time, %

30
28
26
24
22
20
18
16
14
12
10
8
6
4
2
0

Developing Economies

Advanced Economies

1983 1986 1989 1992 1995 1998 2001 2004 2007

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Average Tariff Rates Over Time, %

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Advanced Economies

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Relationship between Tariffs, World GDP, and the Volume of World Trade

30
25
20
15
10
5
0

6000
5000
4000
3000
2000
1000
0

Average applied tariff %

1990 1992 1994 1996 1998 2000 2002 2004 2006 2008 2010

World GDP World Exports

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Tariffs are Widespread

- **Harmonized code** – standardized worldwide system that determines tariff amount.
- In developing economies, tariffs are common.
- In advanced economies, tariffs still provide significant revenue.
- For example, in a given year the U.S. collects more tariff revenue on shoes than on cars (e.g., $1.63 billion versus $1.60 billion).
- The European Union applies tariffs up to 215% on meat, 116% on cereals, and 17% on tennis shoes.

Import Tariffs Have Been Declining

- Governments have reduced tariffs over time, mainly via the General Agreement on Tariffs and Trade (GATT), which became the ***World Trade Organization*** (WTO).
- Economic integration also leads to lower tariffs, but only within economic blocs. E.g., under NAFTA, Mexico eliminated nearly all tariffs on imports from the U.S., but maintains tariffs with the rest of the world.
- China reduced its tariffs since joining the WTO in 2001.
- Firms bypass tariffs by entering countries via FDI. E.g., Toyota built factories in the U.S. partly to avoid tariffs.

Subsidies

- **Subsidies** are government grants (monetary or other resources) to firm(s), intended to ensure their survival or success by facilitating production at reduced prices, or encouraging exports.
- Grants include cash, tax breaks, infrastructure construction, or government contracts at inflated prices.

Subsidies (cont'd)

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<u>Examples</u>

- In China, Shanghai Automotive ($12b ann. sales) and numerous other MNEs are partly owned by the Chinese government, and receive huge financial resources.
- Europe and the U.S. provide huge agricultural subsidies to farmers. EU subsidies represent 40% of the EU budget.

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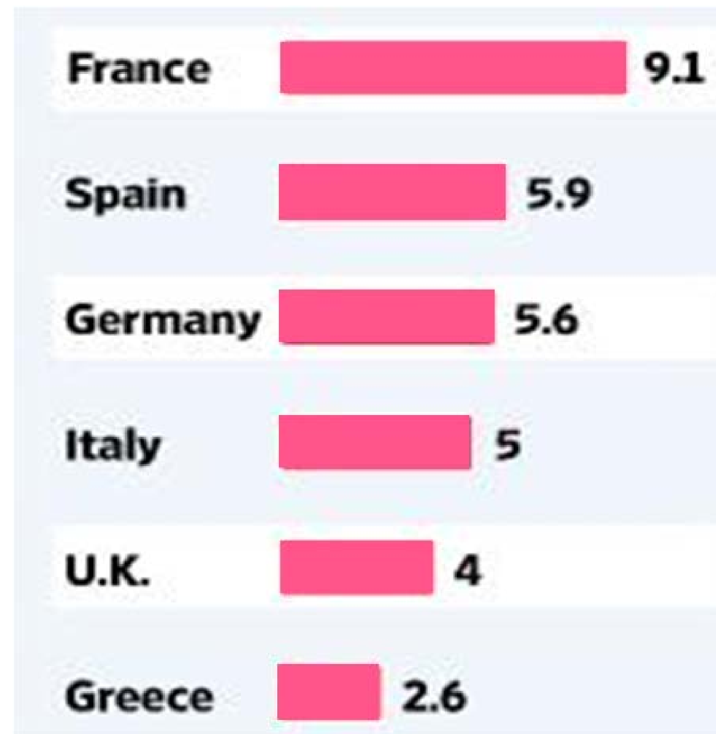
Farm Subsidies in the European Union
(in billions of euros)



Source: Wall Street Journal. Aug 4, 2009. pg. A.7

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Economic Freedom

- ***Economic freedom*** is the absence of government coercion so that people can work, produce, consume, and invest however they want to.
- The *Index of Economic Freedom* assesses the rule of law, trade barriers, regulations, and other criteria.
  - Virtually all advanced economies are ‘free’
  - Emerging markets are either ‘free’ or ‘mostly free’
  - Most developing economies are ‘mostly unfree’ or ‘repressed’
- Economic freedom flourishes with appropriate of intervention; too much regulation harms the economy

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Countries Ranked by Level of Economic Freedom

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Import Substitution vs. Export Led Development

- ***Import substitution*** is a policy of restricting imports in order to protect home-country firms. It was widely tried in Latin America in the 1950s, in an effort to promote industrialization and economic development. But most countries eventually rejected import substitution.
  By contrast,….
- ***Export-led development*** was tried in Singapore, Hong Kong, Taiwan, South Korea, and other Asian countries. This model, which encouraged the development of export-intensive industries, proved very successful and led to rapid economic growth and high living standards.

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Evolution of Government Intervention

- Protectionist tendencies, the Great Depression, and isolationism shaped early 20th century world trade.
- The Smoot-Hawley Act (1930) raised U.S. tariffs to more than 50% (compared to only 3% today).
- Progressive trade policies reduced tariffs after WWII.
- In 1947, 23 nations signed the General Agreement on Tariffs and Trade (GATT). The GATT:
  - reduced tariffs via continuous worldwide trade negotiations;
  - created an agency to supervise world trade; and
  - created a forum for resolving trade disputes.

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The GATT (cont')

- The GATT introduced the concept of ***most favored nation*** (renamed ***normal trade relations***), according to which each member nation agreed to extend the tariff reductions covered in a trade agreement with one country to all other countries. A concession to one became a concession to all.
- In 1995 the GATT was superseded by the **World Trade Organization** (WTO), and grew to include 150 member nations.
- The GATT and WTO presided over the greatest global decline in trade barriers in history.

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Market Liberalization in China

- In 1949, China established communism and centralized economic planning.
- Agriculture and manufacturing were controlled by inefficient state-run industries.
- The country was long closed to international trade.
- In the 1980s, China liberalized its economy
- In 2001, China joined the WTO
- China is now a key member of world trading system

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Market Liberalization in India

- Following independence from Britain in 1947, adopted a quasi-socialist model of isolationism and government control
- High trade barriers, state intervention, a large public sector, and central planning resulted in poor economic performance
- In the 1990s, markets opened to foreign trade and investment; state enterprises were privatized.
- Protectionism has declined, but high tariffs (averaging 20%) and FDI limitations remain.

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Developing economies face high tariffs

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Intervention and the Global Financial Crisis

- The crisis raises new questions about government's role in business and the world economy.
- The crisis arose largely from inadequate regulation and enforcement of current regulations in the banking and finance sectors.
- In response, governments around the world are increasing regulation and examining ways to improve enforcement.

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Global Financial Crisis Intervention: Examples

- U.S. government increased the power of its Treasury Department, the Fed, and FDIC
- The European Union increased oversight of multinational banks and financial institutions.
- The United Nations called for more transparency in financial activities and closure of loopholes that allow excessive speculation in global finance.
- Some governments increased protectionism. Russia raised tariffs on cars and combine harvesters.
- Governments increased subsidies. The EU granted more than $50 billion in aid to Daimler (Germany) and Skoda (Czech Republic) and other carmakers.

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How Firms Should Respond to Government Intervention

- ***Research to gather knowledge and intelligence***. Understand trade and investment barriers abroad. Scan the business environment to identify the nature of government intervention.
- ***Choose the most appropriate entry strategies***. Most firms choose exporting as their initial strategy, but if high tariffs are present, other strategies should be considered, such as licensing, or FDI and JVs that allow the firm to produce directly in the market.

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How Firms Should Respond to Intervention (cont'd)

- ***Take advantage of foreign trade zones***. FTZs are areas where imports receive preferential tariff treatment, intended to stimulate local economic development. E.g., a successful experiment with FTZs has been the maquilladoras — export-assembly plants in northern Mexico.
- ***Seek favorable customs classifications for exported products***. Reduce exposure to trade barriers by ensuring that products are classified properly.

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How Firms Should Respond to Intervention (cont'd)

- ***Take advantage of investment incentives and other government support programs*.**

Examples

- The government of Hong Kong put up much of the cash to build the Hong Kong Disney Park.
- Mercedes-Benz received several hundred million dollars in subsidies to build a plant in the U.S. state of Alabama.

- ***Lobby for freer trade and investment*.** Increasingly, nations are liberalizing markets in order to create jobs and increase tax revenues.

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