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1 Introduction: What is locational policy?

This paper addresses the options for, and limitations to, localised efforts to stimulate and shape economic development, both in industrialised and in advanced developing countries.¹ I define locational policy as the effort of local stakeholders, both from government and non-government, to create a favourable environment for business activities. It aims at improving the locational quality of a region, so that: existing companies may become more competitive, entrepreneurs will find it an attractive location to establish a business, and external investors will prioritise it when making locational decisions. Moreover, it may include pro-active measures to stimulate and support the competitiveness of companies, and shape structural change. Traditional locational policy addressed three issues: (i) making real estate available and improving the infrastructure; (ii) attracting external investors; and, (iii) facilitating communication between the business community and the public sector (Hollbach-Grömig 1996). As locational competition became more intense and unemployment levels rose, local actors in industrialised as well as developing and transformation countries started to pursue a more ambitious approach² which included at least one of the following elements:

- the creation of roundtables, partnerships (including public-private partnerships) or alliances for local economic development in order to formulate and implement a strategy to improve the locational advantage or revitalise old locations (OECD 2001, Wallis 1996, Küpper 2000);
- the implementation of cluster initiatives (Raines 2000, Enright 2000);
- the creation of dedicated local economic development agencies to co-ordinate and organise local level efforts (ILO et al undated).

Why do local players support LED initiatives? The phenomenon of globalisation is the main cause for competition between locations and the necessity for locational upgrading. First, in many if not most industries, firms now have numerous options when it comes to choosing an attractive location. As some locations succeed in quality improvement, others have to follow suit or face being left behind, with local firms moving elsewhere and external investors not shortlisting them. What is emerging is a pattern of competition between localities, i.e. cities, city-regions or other sub-

1 This chapter draws on research from the joint IDS/INEF project "The Interaction of Global and Local Governance: Implications for Industrial Upgrading", as well as research conducted between 1998-2001 in the project "North Rhine-Westphalia: Structural Economic Change and Regional and Locational Policy". The chapter also draws on my experience as a consultant on local economic development in some municipalities in Santa Catarina and in the Greater ABC region, both in Brazil, in Mpumalanga province, South Africa, and in several municipalities in Argentina and Thailand.

2 For the U.S. see Bradshaw and Blakely (1999), for Germany see Meyer-Stamer (1999), and see Helmsing (2001) for developing countries).

national regions. This has been coined 'competitive regionalism' (Jonas and Ward 2001) or 'territorial competition' (Cheshire 2001).

Second, local players may consider an LED initiative even if local companies cannot use relocation as a threat. Local companies have to compete against companies from different home-bases, and if their competitors enjoy the benefits of a more sophisticated location then they pose a serious competitive threat to local companies. They could even squeeze local companies out of the market. In order to avoid this, and the consequent employment and tax losses, local players will try to enhance the competitiveness of local companies.

Third, there are still many locations which are not actively integrated into the globalised economy in terms of supplying goods or services. For players in such locations, the primary motivation is to find access to larger markets so that local companies can grow and generate more jobs and tax income.

The problem is that the implementation of LED initiatives do not usually run smoothly, although this is not necessarily due to the reasons elaborated in the academic literature. For instance, the LED and the cluster discussion assume that the respective locality is integrated into the economy at large and this is the starting point for LED initiatives. It is rare to find an analysis of the restrictions that the connection between a local economy and the global economy creates for LED efforts. In the international political economy literature, for example, it is more common to find the argument that the global economy determines what can be done at the local level. Thus, the usual conclusion is that very little can be done (e.g. Menzel 1995). This argument can easily be falsified, as a number of successful LED initiatives have documented (e.g. Aghón, Albuquerque & Cortés 2001). My own recent research and advisory work has been centrally concerned with LED, and I consistently found various opportunities for LED initiatives, some of which rendered surprising successes (Meyer-Stamer 2000).

Nevertheless, in this paper I will argue that our current understanding of promoting local economic development is inadequate, and I will attempt to improve our understanding using an actor-oriented approach. I will concentrate on two features that have not been raised in the literature so far, namely the upgrading paradox and the location paradox. The upgrading paradox addresses the goal of locational policy, namely upgrading companies to make them more competitive and upgrading the location to create employment and increase the tax base. I will show how difficult it is to get a clear understanding of what we mean by upgrading (Section 2), and that upgrading is a vague goal (Section 3). Moreover, the options for upgrading change with the industrial life-cycle (Section 4). I will then focus on the irony of upgrading, i.e. as locational upgrading takes place, the conditions for locational policy deteriorate (Section 5). Finally, the locational paradox addresses the governance pattern of locational policy, and in particular the involvement of the private sector (Section 6). Despite these problems, there are ample options for locational policy, since apart from strategic locational policy it is also possible to pursue generic or reflexive locational policy (Section 7).

2 What is upgrading?

At first glance, the issue of upgrading appears to be straightforward enough. For a firm, upgrading means getting better – producing better products and producing them in a more efficient way. However, things are more difficult than that. Take the example of a garments manufacturer. Developing a new line of products every three months does not really imply upgrading. It is rather a routine in this business. However, if the firm has produced T-shirts, sweatshirts and polo-shirts for a number of years and then decides to also include jeans and shirts in its product portfolio so that it can offer a more complete product range and thus establish a competitive advantage, this is clearly a case of upgrading; in this case product-related. Also, if it establishes its own unit with sophisticated finishing machines, so that the products shrink less and stay in shape for longer, it is upgrading; in this case process related. However, there are also other options for upgrading which go far beyond these upgrading activities, such as forward integration by setting up a franchise network or even opening its own shops.

Recently, there have been efforts to formulate typologies for this kind of upgrading, particularly with respect to developing countries which suffer from 'immiserising growth' (Kaplinsky 2000) due to insufficient upgrading. Humphrey and Schmitz (2001) argue that there are four types of upgrading:

- Process upgrading: firms can upgrade processes - transforming inputs into outputs more efficiently by re-organising the production system or introducing superior technology.
- Product upgrading: firms can upgrade by moving into more sophisticated product lines (which can be defined in terms of increased unit values).
- Functional upgrading: firms acquire new functions (or abandon existing functions) so that they increase the overall skill content of their activities. For example, they might complement production with design or marketing, or move out of low-value production activities altogether.
- Intersectoral upgrading: firms apply the competence acquired in a particular function of a chain to move into a new sector. For example, competence in producing TVs is used to make monitors and thus move into the computer sector. Such horizontal moves into new sectors seem to have been central to Taiwan's ability to gain a foothold in skill intensive sectors (Humphrey and Schmitz 2001). This typology is related to the example outlined above. However, It is not entirely satisfactory. To understand its weaknesses, it is useful to refer to the argument developed by Porter (1996), who conceptualises upgrading in an unconventional way:

The quest for productivity, quality, and speed has spawned a remarkable number of management tools and techniques: total quality management, benchmarking, time-based competition, outsourcing, partnering, re-engineering, change management. Although the resulting operational improvements have often been dramatic, many companies have been frustrated by their inability to translate those gains into sustainable profitability (Porter 1996: 61).

Underlying this, Porter argues, is the fact that firms confuse operational effectiveness with strategy. "Operational effectiveness (OE) means performing similar activities better than rivals perform them" (ibid, 62). "OE competition shifts the productivity frontier outward, effectively raising the bar for everyone. But although such competition produces absolute improvement in operational effectiveness, it leads to relative improvement for no one. (...) major productivity gains are captured by customers and equipment suppliers, not retained in superior profitability" (ibid, 63).

The more benchmarking companies do, the more they look alike. The more that rivals outsource activities to efficient third parties, often the same ones, the more generic those activities become. As rivals imitate one another's improvements in quality, cycle times, or supplier partnerships, strategies converge and competition becomes a series of races down identical paths that no one can win (ibid, 64).

The way out of this trap, according to Porter, is strategy: "Choosing to perform activities differently or to perform different activities than rivals (ibid.).

With most companies striving for operational effectiveness, the reality of competition in globalised markets is often running to stand still. A company which is standing still altogether, i.e. does not pursue some kind of upgrading all the time, has little chance of survival. Whereas, a company which puts a lot of effort into upgrading does not necessarily improve its competitive position.³ This is particularly true for clusters, where competition is localised and particularly strong and visible. For this reason the first part of the Humphrey and Schmitz (quoted above) is not entirely adequate. Increasing the skills content is something firms have to do all the time to maintain their competitive position. This is, in the words of Porter, about operational effectiveness. It is about performing activities in a different way to how they performed them in the past, but not necessarily about performing activities in a different way to their rivals. Porter would be more likely to recommend moving into market niches which have entry barriers in terms of strategy, although this does not create a strategic difference vis-à-vis competitors if it just implies copying the activities of more sophisticated rivals. It is not unusual to observe several competitors trying to move into the same market niches. By focusing on the four types of upgrading suggested by Humphrey and Schmitz, the same argument applies to process upgrading and functional upgrading. Although both are typical manifestations of operational effectiveness, they do not improve a company's competitive position. In the future we need to rethink the concept of upgrading, and acknowledge that it must be a relational category that does not compare a company's, cluster's or location's previous practice with current practice, but looks at their position vis-à-vis main competitors instead.

3 This explains the otherwise somewhat discouraging story of Nadvi and Kazmi (2001), who find that although surgical instruments firms in Sialkot, Pakistan, have gone through tremendous upgrading during recent years, their position in the global value chain has not changed. Likewise, Gibbon's account of failed efforts by garment manufacturers in Mauritius to integrate into downstream activities in the value chain shows that these firms are only just competent enough for the 'running to stand still' scenario, but not sufficiently competent for functional upgrading (Gibbon 2000, 42).

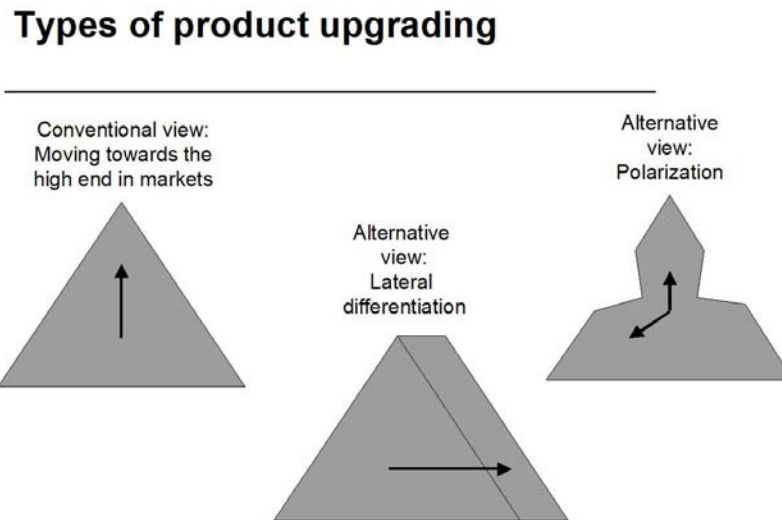
3 Upgrading, downgrading and sidestepping

The upgrading discussion has a further shortcoming: it implies that the term upgrading means to move up. However, companies may choose different options. For instance, in her case study of the Brenta footwear cluster, Rabellotti (2001) tells a story of voluntary downgrading. In the past, shoe producers worked with buyers in Germany, for example, offering their own design and taking an active role in marketing. However, as competition on the German market became more intense, some producers opted to become sub-contractors of Italian luxury brands. Thereby upgrading their products, but downgrading their companies' competences by dropping the design and the marketing function, i.e. activities which one would usually recommend as key activities for upgrading and increased earnings.

This strategy by Brenta firms was based on the fact that the luxury end of the shoe market rapidly increased in the 1990s. However, product upgrading does not necessarily enhance competitiveness and create economic success. There is the risk of upgrading products so much that they lose their market base. The German capital goods industry provides a cautionary tale. This industry eventually created such sophisticated machine tools that they became far beyond the requirements of most customers (Widmaier 1998). In other words, not only is there the 'sandwich situation' frequently encountered by producers in newly industrialising countries, which are caught in between technologically superior competitors in industrialised countries and lower-cost producers in less-advanced countries. There is also a 'thin-air situation' encountered by high-end producers which try to upgrade further, thus creating increasingly elaborate products which are beyond the requirements of their customers.

In our investigation of the ceramic tile industry, we found yet another pattern, namely simultaneous product upgrading and downgrading (Meyer-Stamer, Maggi and Seibel 2001). Italian producers in particular are famous for their high-end tiles, with unique designs in terms of colour and surface structure. However, these producers put a lot of effort into entering into arrangements with large retail chains in locations such as Germany even though this is not the typical place to sell high-end tiles. The tile producers manufacture private brands for these chains, which are sold at low prices. This behaviour is rational for two reasons. First, the tile market seems to display, at least in countries with a mature retail structure, a tendency towards polarisation, i.e. the high-end is growing, the low-end is also growing, whereas the medium segment loses importance. For companies, it is attractive to have a presence in both the high- and the low-end as long as the low-end products do not cannibalise [over-take?] the high-end products. With differentiated design and the existence of private brands, this risk is low. Second, even though the margins, and perhaps even the absolute earnings, at the low-end are smaller, the scale of production is larger, thus permitting a quicker amortisation of new equipment. As new equipment plays an important role in product upgrading, this may create the economic base for continuous investment in new machinery and thus, ironically, for constant innovation in the high-end product segment.

Figure 1



The pattern observed in the tile industry is depicted by the right-hand figure in Figure 1. How can the centre figure, i.e. lateral differentiation, be explained? The Swedish apparel retailer Hennes + Mauritz and its Spanish competitor Inditex/Zara are examples of this pattern. They have created a new segment of the market, i.e. low-price, highly differentiated garments (Capell, 2002, Bonnin 2002). By renewing the stock in their shops on a fortnightly basis, they cater in particular to the demands of young customers who want to look different from their peers. In some other U.S. stores, the renewal rhythm has been reduced to one week. From a retail perspective this means moving sideways rather than upwards. In terms of price, they compete with traditional retailers such as C&A or The Gap, whereas in terms of product differentiation they create a segment of their own. From a supplier perspective, it implies process upgrading. Lee-Young and Barnett (2001) describe the example of Li & Fung, a supply-chain co-ordination firm located in Hong Kong, 'one of the speediest suppliers on Earth' (see also Magretta 1998).

What does all this mean for companies' efforts to upgrade? Essentially, it comes back to the Porter argument: upgrading is not a priori about a direction, such as upwards. Instead it is more about productive rent-seeking (Kaplinsky 1998). Upgrading means doing things differently, and/or doing different things – not different compared to previous practices in the same company, but compared to competitors.

For locational policy makers, this means that it is difficult to formulate activities to support upgrading activities. Upgrading is much more contradictory and confusing than the Humphrey/Schmitz-typology would suggest – the direction is a priori unclear, and therefore it is difficult, for instance, to assess the necessities in terms of factor conditions resulting from companies' upgrading efforts.

4 Territorial upgrading and the life cycle paradox

My reflections on upgrading so far have been related to the Humphrey/Schmitz typology. Their consideration of upgrading addresses companies, not locations per se. A different approach to defining types of upgrading, seemingly with an explicit focus on the territorial dimension, has been suggested by Gereffi (1999):

Industrial upgrading is a process of improving the ability of a firm or an economy to move to more profitable and/or technologically sophisticated capital and skill-intensive economic niches. Industrial upgrading operates at several different levels of analysis: (1) within factories—upgrading involves moving from cheap to expensive items, from simple to complex products, and from small to large orders; (2) within inter-firm enterprise networks—upgrading involves moving from mass production of standardized goods to the flexible production of differentiated merchandise; (3) within local or national economies—upgrading involves moving from simple assembly of imported inputs to more integrated forms of OEM [original equipment manufacture] and OBM [own-brand manufacture] production, involving a greater use of forward and backward linkages at the local or national level; and (4) within regions—upgrading involves shifting from bilateral, asymmetrical, inter-regional trade flows to a more fully developed intra-regional division of labor incorporating all phases of the commodity chain from raw material supply, through production, distribution, and consumption (Gereffi 1999: 51 f).

This typology has two shortcomings. First, Gereffi suggests that regional upgrading is the sum of the upgrading of firms in the region. To an extent this is the case, as the companies' success is the result of certain policy initiatives, i.e. locational policy, technology policy, competitiveness policy, etc. But in another sense it is not a useful typology since it is merely descriptive, i.e. it does not elaborate in terms of analytical foundation. Crucial analytical questions are: Did the firms upgrade because locational factors improved, or despite the fact that they remained minimal? What was more relevant: intra-firm effort, inter-firm collaboration, locational policy efforts, or overall macro-economic conditions?

Second, it is no coincidence that the typology looks like a generalised description of what has happened in East Asia during the last few decades. In fact, much of Gereffi's research has focussed on this region. This line of thinking on upgrading is very much based on the Japanese, Korean and Taiwanese experience during the 1960s to 1980s. The upgrading of the Japanese and Korean economies (and to a lesser extent that of Taiwan) occurred during a period when industries were predominantly organised along Fordist principles. This leads us to question how the phase of a long cycle affects upgrading. It is certainly true that today we are in a different phase of the cycle than in the 1970s. For example, this is what all the discussion on flexible specialisation since the 1980s has been about. Perhaps this has grave consequences for upgrading, and perhaps the East Asian experience has only limited relevance today (but will become relevant again in 20 years or so). But so far we do not really know, since the issue of the industrial life cycle has been neglected in the recent upgrading debate.

However, the implications of the industrial life-cycle on location have been addressed both from a practitioner's and from a researcher's point of view. **Table 4.1** gives a practitioner's view. Its basic message is simple and straightforward: In the early phase of the life-cycle, companies rely on a sophisticated environment. In the later phases, they move to locations where production factors, in particular real estate and labour, are cheap.

Table 4.1 Requirements on locations across the industry life-cycle

Start-up phase	Growth phase	Maturity phase	Decline phase
Highly skilled workers Knowledge infrastructure Proximity to customers	Proximity to market (up- and downstream) Specialised workers Highly skilled workers Real estate	Cheap workers Low location cost Proximity to market	Cheap workers Low location cost Little regulatory cost

Source: Pieper (1994), p 32

Interestingly, the practitioner's view, which is mostly based on experience and inductive reasoning, is confirmed by more systematic research that addresses the issue of locational quality from an innovation economics perspective. This is summarised in **Table 4.2**.

Table 4.2 A neo-Schumpeterian model of industrial development

Stage of industry Parameter	Innovative	Competitive	Oligopolistic	Decline
Localisation pattern	Close to existing pools of high-skilled labour/ founders residence	Firms are attracted to least cost sites (labour, land, taxes, etc.)	If early: relocation is retarded because market strategies are better implemented from old centres. If late: reorganisation of industry to less unionised labour	Close down operations in old industrial regions. Modernised plants in new regions.
Importance of proximity	Agglomeration economies are high. Attraction point: innovative centres.	Proximity to competitors/ colleagues less important. Proximity to producers of equipment of some importance	Firms operate on larger in- and output markets. Internal division of labour and level of information rises.	Low
Growth	High growth rates. Employers from established firms form spin-off firms	High. Minimum optimal scale increases and spin-off becomes rare.	Low. Markets are increasingly organised and negotiated.	Negative
Technological development	Product innovations have primacy. In many cases production equipment is modified by the user	Products are standardised. Process development aimed at economies of scale.	Product differentiation (fashion) and process development dominates	Product development suppressed by short term profit dispositions. Process developments are rare.

Source: Gelsing (1992), p 128

What does this mean in terms of upgrading, both for companies and for locations? In terms of locations, the answer seems to be simple and, to some extent, discouraging. There is a lot that can, and indeed should, be done to support the emergence of new industries. Yet, there is little that can be done, in particular on the part of 'old' locations, with respect to mature and declining industries. But also 'new' locations, such as greenfield sites⁴ in developing countries that cater to relocated plants in mature industries, do not have many options in terms of locational policy. The practitioner's viewpoint is straightforward: minimise costs of infrastructure, real estate, labour and skills development. This is exactly what has been happening in locations that were successful in attracting greenfield investments in mature industries (Kanter 1995).

What about the experience of companies in mature industries that become involved in elaborate locational policy efforts? An example would be the involvement of Volkswagen in locational development and upgrading in the region around its main facility, Wolfsburg. This, however, is a somewhat special case. The company started as a state enterprise, and state government is still an important minority shareholder. This creates a form of shareholder pressure that is different from the usual pressure that primarily addresses financial returns.

One would expect, therefore, that at least locations with emerging or growing industries are favourable places for locational policy. However, this expectation is based on an analysis which looks at economic factors; the scenario changes if we introduce political factors. This leads us to question appropriate governance patterns for locational policy. Basically, there are two options: hierarchy and networks. Hierarchy is the traditional pattern of public governance. Government formulates and implements a policy after a certain amount of fact-finding and interaction with special interest groups. This may be an adequate pattern for areas such as environmental policy, where government should take care of the common good and protect its citizens. However, it is not an adequate pattern when it comes to activities such as industrial policy (at the national level) and locational policy (at the local level). The argument put forward by neo-liberal economists, namely that there is no reason to assume that government co-ordination is superior to market co-ordination when it comes to business promotion, is convincing. However, this does not mean that government has to limit itself to facilitating markets, since there are cases where market failure is persistent (Meyer-Stamer 2001). Experience in industrialised countries shows that government actors are involved in policy networks which also include various non-governmental actors, and which may be quite effective in formulating and implementing sectoral policy (Messner 1997). Policy networks are rarely designed and created intentionally. Instead, they emerge as a spontaneous response to governance requirements, for example market failures which block rapid adjustment processes in old industrial regions.

So why is the involvement of policy networks problematic in locational policy? The problem is that functioning policy networks involve collective actors, rather than a large number of individuals or companies. Effective policy networks for locational policy require effective business organisations. This is where the difficulty arises

⁴ This term refers to new sites, built on metaphorical 'green fields'.

and it is related to the industrial life-cycle. Entrepreneurs in emerging industries feel little pressure to organise themselves and look for political support. Similarly, industries and firms that are growing rapidly do not feel the need to fight for their interests. They are so busy managing rapid growth that they do not have time for such activities. As a result, there is no immediate logic for collective action under such circumstances. Although policy makers may strive to support such industries in order to defend common interests they are still faced with the difficulty of establishing adequate communication links with new firms because they have not (yet) organised themselves.

At the same time, old industries tend to be well organised for the simple reason that there is a logic of collective action, namely to lobby for defensive measures to slow down the adjustment process. Therefore, for government policy makers it is easy to tap into policy networks with mature and declining industries. However, as I have argued above, this kind of industry is not very interested in locational policy.

This is the life-cycle paradox of locational policy: industries which might be interested in locational policy are unlikely to be well organised, therefore, it is difficult to establish the policy networks required for policy formulation. Old industries are well organised, but they are not interested in locational policy.

5 Value chains and the irony of upgrading

So far, I have looked at the intrinsic problems of locational policy, without looking at the specific repercussions of globalisation on locations. Global competitive pressure is the main reason why local stakeholders start locational policy initiatives. However, as we will see, it is also a major complicating factor for locational policy. This section addresses some implications concerning globalisation of product markets for locations. More specifically, it addresses the implications of global value chains for locational policy making.

Before focusing on the interaction between locations and value chains, it is important to note that there are basically two different constellations: locations may or may not be an important issue for those co-ordinating a given value chain. Increasingly, the co-ordinators of value chains are global buyers that systematically scan the globe for potential suppliers. If the location is not yet a priority for the buyer then the conditions for locational policy are fairly reasonable. This is a typical scenario in many emerging locations in developing countries (the argument developed in this section is less relevant for industrialised countries). A great deal of SME promotion is based on this scenario. The objective here is to increase the competence of local firms in terms of production, quality, technology, human resources and financial management, so that they can manufacture products of acceptable quality at competitive prices in the hope that they may attract recognition from global buyers. ISO 9000 seems to play an important role in this respect as it indicates to global buyers that a local firm has the potential to become a supplier (Quadros 2002, Nadvi and Wältring 2002).

Prior to detection from global buyers, upgrading means learning within local markets or elsewhere to improve competitiveness in order to be noticed by value chain scouts. Government may take an important role, for instance pursuing a carrot-and-stick

approach, i.e. both pushing and pressuring firms whilst supporting them, including dedicated efforts to raise their profile (missions abroad, presence at fairs, joint marketing etc.).

What are the consequences of raising their profile and attracting orders? The most likely and immediate consequence is rapid growth. Managing rapid growth is extremely time consuming for firms. As a result, there is little time for interaction with government or other players which are not directly related to day-to-day business. If orders keep coming in, there is also little urgency for collective action. Constellations like this have been observed in the early growth phases of the footwear cluster in Sinos Valley, Brazil (Bazan and Schmitz 1997), and the furniture cluster in São Bento do Sul, Brazil (Meyer-Stamer 1998).

Another important aspect is that once they have raised their profile, the chain governor (i.e. usually a global buyer) is unlikely to expect local government to play an active role in day-to-day management. Instead, they expect government to remove obstacles that stand in the way of day-to-day business (red tape, deficient infrastructure). For the chain governor, shaping the chain is a crucial element of their effort to create a competitive advantage, and it is unlikely that they would want to share their concepts and strategies with other players. Particularly not with local governments in the places where suppliers are located. The chain governor becomes the main source of information, training, advice etc. Local suppliers prioritise communication with their new big customer. Government officials find themselves increasingly isolated from the communication loop, relying on second-hand information on the evolution of the chain.

But what about private governance, and local collective action within the business community in particular? For local companies, becoming part of a global value chain may imply four different scenarios:

- a) Product and process upgrading. Often this mainly concerns running to stand still. It implies joint upgrading with other participants in the value chain. This is a challenging task that involves only a limited risk. It is in everybody's interest including the global buyer, who is also interested in fundamental activities, to improve locational quality, such as infrastructure and vocational training institutions.
- b) Strategic functional upgrading. This entails taking over functions previously handled by other companies, usually from other locations within the same value chain. This is a more risky option, as the to-be-replaced competitors will probably fight back. Global buyers may be expected to tolerate this (as long it does not threaten their own core competence), as fierce rivalry between locations strengthens their bargaining position vis-à-vis each of them.
- c) Improve their competitiveness in order to move to a different value chain. In a given sector, there are various value chains that cater for different segments of the consumer market. As long as margins are higher in more sophisticated or in differentiated markets, it may be tempting to switch from one value chain to another that serves higher-margin markets. This involves the risk of falling between a rock and a hard place; the old buyer may anticipate this and move to a different source, whereas the prospective new buyer might fail to close the deal.

- d) Attempting to take over the value chain or trying to take the main power position in the value chain. This is clearly the most challenging option. It may be viable in cases where the buyers power position is limited; the ceramic tile industry is case in point (Meyer-Stamer, Maggi and Seibel 2001).

What is the role of private sector collective action in these different scenarios? In all four cases there are strong incentives against collective action. In the case of scenario A, one might argue for a positive-sum game⁵ which might persuade firms to go for collective efforts to upgrade, particularly in a situation where all the firms in the location are suffering from superior competition from another location. For example, the case of the Sinos Valley footwear cluster vs. producers in China (Schmitz 1995). However, it is more likely that firms will think in terms of a zero-sum game, i.e. a firm perceives the loss of local competitors as its own gain. This is particularly likely in places where collective action has suffered from early export growth.

In the case of scenarios B to D, collective action is even less likely. It is highly unlikely that in a given location all company decision-makers will display the same level of risk-friendliness; probably the most important risk is to be abandoned by current buyers. If the degree of risk-friendliness diverges, one might expect that some decision-makers would find all of these scenarios plausible, whereas many others would not. One would expect that particularly risk-friendly, strategically oriented firms would go for one of these options, thus creating a split among business executives within the location.

What is the role of government in these different scenarios? Basically, it would try not to stand in the way (i.e. reduce transaction costs) and to excel in the provision of basic and advanced factors. The case study of Halder (2002) on the surgical instruments cluster in Tuttlingen, Germany, illustrates this point. It seems improbable that government can play a major role, in particular with respect to scenarios B to D. It is unlikely that government has the in-depth, up-to-date knowledge that is necessary to assess the viability of these scenarios. The most likely contribution of government may be to contract a specialised consultancy firm to support local businesses and associations in their decision-making process.

So this is the irony of upgrading and entry into value chains: Government can play a very important role in locational policy by helping local firms become so competitive that they are sub-contracted by global buyers. However, as the firms get involved in the value chain, the options in terms of governments role in locational policy declines substantially, and it can be expected that collective action in the private sector will suffer as well.⁶

⁵ Games where both parties can gain, as opposed to zero sum games, where one party's gain is another's loss.

⁶ This would be an alternative interpretation of the case presented by Leite (2002) about different records of locational policy in the ABC region of Brazil with respect to the car industry and the plastics industry. According to her presentation of the plastics industry, it appears like an industry that has not yet been detected by external buyers.

6 The location paradox

This section addresses the implications of globalising companies for locational policy. The globalisation of companies may occur by a local company establishing branch plants, taking over companies in other countries, or the take over of local companies by foreign investors. I argue that locational policy makers are confronted with a paradox: Globalising companies are increasingly demanding when it comes to locational quality, but they show a declining propensity to get actively involved in locational policy.

Increasing demands in terms of locational quality apply to various locational factors: high quality and low cost infrastructure, swift execution of licensing and permit processes, low tax burden, substantial effort in workers' training, etc. Companies discussed in this section sell a large part of their output elsewhere. This section does not address local companies such as developers or utilities which will often take a very active role in locational policy. For these companies, locational upgrading is a key element of their business strategy which aims at keeping and attracting customers. This discussion on the relationship between location and competitiveness focuses on industrial manufacturers and service firms that are supplying global markets.

The declining propensity of companies, in particular large, multi-location companies, to get involved in locational policy has been documented in a number of case studies (Heying 1997, Dörre 1999). Yet, why would one expect that such companies to become involved in these activities in the first place? This suggestion is based on inductive reasoning: Despite globalisation, companies are not usually footloose, and they do not pick locations randomly. Space and location continue to be relevant for globalised manufacturing and service companies (Porter 2000). Companies seek specific locational qualities. This implies that companies have an interest in the creation and improvement of locational qualities, therefore, they may be willing to take an active role in this respect.

Let us now take a closer look at the connection between company and location. Companies are located in a given place for three possible reasons:

- a) historical accidents (i.e. because they were founded there or because they acquired a firm which happened to be located there);
- b) they are seeking proximity to other firms. A typical example would be an IT company that sets up an affiliate in Silicon Valley;
- c) they strive to build up a presence in proximity to dynamic markets; or,
- d) they are seeking other locational factors, such as natural resources or cheap labour. For example, Renschler (1995) gives a detailed account of the criteria Daimler-Benz applied when it scanned possible locations for its SUV factory in the U.S.

These motives do not necessarily mean that a company deliberately contributes to the improvement of locational quality. In particular, cases B to D are more about receiving benefits but they do not contribute towards them. Instead, companies will often contribute inadvertently to locational quality improvements, i.e. while enhancing

their own competitiveness they create positive externalities. Conversely, one of the main obstacles to getting companies involved in a locational strategy is the problem of free-riding, i.e. companies' assume that collective action renders too little outcome which they can appropriate for themselves and too much externality which benefits local competitors.

There are two types of location where one would expect this problem to be less relevant:

- hub-and-spoke-clusters (Markusen 1996), which are essentially dominated by one company (e.g. Toyota City or Wolfsburg), where the 'hub' company can control the external effects; or,
- very cohesive clusters, where free-riding is minimised through social control. However, this phenomenon is becoming rare as local firms in cohesive clusters get involved in international value chains, and external firms enter into local clusters to benefit from specific locational qualities (Grabher 1993). Strong cluster cohesion is probably more closely related to the life cycle of companies and their industry rather than to location.⁷

This is not to say that companies do not do anything to the benefit of their location. What they usually opt for is sponsoring – of museums, theatres, other cultural events, sports, etc. For a large corporation, sponsoring has an unbeatable cost-benefit-ratio, i.e. the cost is usually relatively low, whereas the visibility is high, and, moreover, the company can point at such sponsoring activities whenever somebody criticises it for lack of local involvement. Furthermore, the cost-benefit-ratio is much more predictable than in cases where companies become involved in locational policy. Understanding the structure of local policy networks, and participating in them, will involve substantial input in terms of time (i.e. high transaction and opportunity costs), whereas the visibility of the outcome is unpredictable. How is a company that is driven by the rationale of shareholder value maximisation supposed to justify this kind of involvement? This logic becomes even more convincing if one considers that companies tend to run operations in many different locations, and that they are likely to have an exit option that may be particularly attractive in the case of simple screwdriver operations⁸.

7 Conclusion

Over the past few years there has been an increasing degree of excitement about the potential benefits of local economic development efforts, both in industrialised countries

⁷ This is an important point made by Bazan and Schmitz (1997).

⁸ This refers to basic assembly plants where parts/components are attached to each other (with a screwdriver).

and developing countries.⁹ The purpose of this paper is not to dampen this excitement. However, it is important to come to a realistic assessment of the latitude of locational policy, and the typical obstacles that every locational policy initiative will have to deal with. If such an initiative does not make the swift progress that local actors had hoped, it is quite likely that the issues addressed in this chapter are to some extent responsible.

Local governments may be tempted or obliged to formulate a local upgrading strategy, i.e. a locational policy. They frequently choose strategic locational policy, i.e. an effort to formulate an overall, long-term strategy for upgrading local companies and the location. This is an enormous challenge. Aligning all the relevant local players, agreeing on a problem definition, negotiating an action plan and distributing and coordinating tasks and responsibilities among various players is even difficult for those locations where local stakeholders have decades-long experience in local economic development. It is not surprising, therefore, that strategic plans for local development often do not get beyond the stage of printing a plan that will never be implemented.

However, there are less challenging options. Local government may try to implement a generic locational policy that targets obstacles to business created by the various layers of government. In fact, government is often one of the biggest problems faced by companies, since it frequently introduces questionable regulations and constrains businesses with a multitude of permits and registration requirements. Streamlining local government's interaction with businesses in order to minimise transaction costs can make an important contribution to companies' competitiveness, and may substantially enhance the locational quality and competitiveness.

A third option is reflexive locational policy. It is an approach that we have observed in the ceramic tile cluster in Castellón, Spain (Meyer-Stamer, Maggi and Seibel 2001). Local players did not attempt to go for the strategic approach. Instead, they participated in an exercise that involved a series of studies and workshops, organised by the leading regional bank that took place over the duration of several months. The purpose of the exercise was to improve the information base of all the players in the cluster, so that each actor could develop their own strategy. It is a good example of a semi-public actor rectifying a market failure, because individual companies would not have had access to such high-quality information, let alone the opportunities for reflection which emerged through discussion both inside and outside the workshops.

The concept of reflexive locational policy takes us back to the discussion on upgrading. If players in a given location succeed in setting up institutions (perhaps in the shape of an organisation, but more likely by establishing routines) that foster constant reflection then this will contribute to the companies' upgrading efforts. It will also establish an element of locational upgrading. It addresses issues such as the innovativeness of the local milieu, the local innovation system, or the knowledge-intensity of local development from an unusual angle. The standard approach is concerned with product and process innovation. Reflexive locational policy is about innovation in local govern-

9 For industrialised countries see European Commission (1998), OECD (2000). Regarding developing countries see Helmsing (2001). An overview of organisations involved in LED work is available at www.meyer-stamer.de/led-links.html.

ance, and upgrading the information base of all economic players in the location. In fact, for public-sector players involved in locational policy, it solves the dilemma of upgrading to some extent, as it is not always up to them to decide which route companies are to follow in their effort to establish a competitive advantage. Local government may be ignorant about businesses' strategy decisions and yet still pursue a useful generic locational policy. This may even include the provision of sophisticated locational factors, such as specialised training, R&D or finance, since there is no a priori reason why such factors have to be supplied by public agencies, especially in a place where reflexive locational policy works. As a result, the uncertainty for private providers of such services are substantially reduced.

It is important to point out that the three types of locational policy, i.e. generic, reflexive and strategic, cannot easily be ranked in terms of relevance or effectiveness. Furthermore, there is not necessarily a ladder, i.e. a sequence whereby local stakeholders go through a learning process that starts with a generic locational policy and leads, via a reflexive locational policy, to a strategic locational policy. The type of locational policy that is most adequate for a given territory is highly location and life-cycle dependent. A location that is thriving due to dynamic firms and market processes is probably well served with a generic locational policy. Actors in a location with a highly diversified economic structure will probably find it difficult to start a reflexive locational policy. This kind of approach appears more promising in locations with a somewhat narrower specialisation profile, in particular industrial clusters. Strategic locational policy is a very difficult approach, which is most likely to happen in places suffering from profound crises. Every location ought to pursue a generic locational policy. Some may find it useful and viable to pursue a reflexive locational policy, while very few will succeed in formulating and implementing a strategic locational policy.

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