

Cambridge University Press & Assessment  
978-0-521-86845-7 — Strategies, Markets and Governance  
Ralf Boscheck, Christine Batruch, Stewart Hamilton, Jean-Pierre Lehmann,  
Caryl Pfeiffer, Ulrich Steger, Michael Yaziji

Excerpt

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# Part I

## Introduction and overview

# 1 Strategies, markets and governance

Ralf Boscheck

Every day, the news reminds us that the terms making up the title of this book are sadly at odds. We had just sent the manuscript to the publisher, when the European Commission released the findings of its energy sector competition inquiry, concluding that industrial customers and consumers were losing out due to inefficient gas and electricity markets.<sup>1</sup> The report pointed to high levels of market concentration; anti-competitive integration of generation, networks and supply; unequal access to, and insufficient investment in infrastructure, and, possibly, market sharing cartels between operators. Going forward, the Commission intended to prosecute individual cases under EU competition rules and to further liberalize the sector, if necessary against the will of national governments.

At the end of 2006, the average annual salary of a programmer in Hungary ranged from \$4,000 to \$7,000, in India from \$5,900 to \$11,000, and in the USA from \$60,000 to \$80,000. The annual cost of a chip designer in Suzhou (China) was \$24,000, i.e. \$4,000 less than in Shanghai, \$6,000 less than in Bangalore, \$276,000 less than in Boston.<sup>2</sup> Business reacts by outsourcing, offshoring, and relocating production. For recipients, outsourcing provides employment, substitutes for imports and generates export earnings; for outsourcers and importers, like WalMart, contributing nearly one-fifth of China's total export volume, it sustains "every day low prices" to consumers. Still the ILO, WTO, EU, and NAFTA push for internationalizing employment standards and their enforcement through product labeling, trade sanctions and consumer boycotts. Harmonizing labor rights blocks regulatory competition and social degradation; but it also limits development options, protects inefficient practices and raises costs to consumers.

Ongoing healthcare reforms in the US, Germany and the UK are market-driven.<sup>3</sup> Economic motives affect treatment options, patients' choice and payers' financial commitment; they may also result in unwarranted exclusions from vital cures and generally the supply of sub-optimal healthcare.

<sup>1</sup> EU Press Release, IP/07/26, Brussels, January 10, 2007.    <sup>2</sup> [www.cio.de](http://www.cio.de), last visited January 12, 2007.

<sup>3</sup> Boscheck, R., (2004) Healthcare reforms and patient rights, *Intereconomics*, 39(6), 310–13.

Responding to evident risks, countries rely on a mix of market and judicial reviews, regulatory oversight and corporate self-regulation. But procedural and substantive standards are generally unclear and private rules are seen to require public supervision. How can patients, care suppliers and authorities determine whether a given service is fairly offered in competitive markets, requires stronger incentive contracts, or demands direct regulatory control? How should courts pass judgment? What ultimately legitimizes healthcare markets?

Concerns about strategies, markets and governance and how they interact are hardly new. Every day, the news scrutinizes markets and regulatory outcomes and holds private and public actors accountable based on some norm of solidarity, efficiency, equity or fairness. What may be new is that a much larger number of individuals, organizations and nation states on an ever-expanding range of issues reach around the world faster and deeper than ever before. The result is increased complexity in dealing with stakeholders, uncertain motifs, cross-cutting agendas and legitimacy concerns. This chapter offers a perspective: It explores the notions of strategy, market and governance, links them to a framework for assessing a hierarchy of inter-related coordination decisions and structures the contributions to the book.

## 1. By way of introduction – concepts and cases

Strategies, markets and governance are such familiar concepts today – so why make an effort to explain them at all? After all, one expects private or public actors to use strategies to drive policies and regulations, create markets or shape their structure, conduct and performance. Markets are understood to induce economic activity, allocate resources and rewards and contain or balance the impact of private and public ventures. Governance mechanisms are known to enable and substitute for market and non-market coordination. And yet, while these concepts appear to be well established and to constitute each other, they often actually relate to quite different views on man, his primary motifs and need for authority. In fact, the dominance of any given implied motivation could easily give rise to distinct conceptualizations of institutional, economic and social structures, from the libertarian society to the command economy, whose coexistence alone requires coordination. As strategies, markets and regulations spread, would one such model win out or diversity persist and some common ground be recognized? This section explores the terms and connotations.

## Strategies

Almost since its foundation in 1908, the Harvard Business School, possibly *the* reference for modern business strategy thinking, required aspiring managers to enroll in a course on “business policy.” Classes and case teaching methods called on participants to shed functional preoccupations and instead develop an integrative and deliberate response to market opportunities and threats. Emulated around the world, the course’s curriculum has since been adjusted in line with commercial and industrial developments and advances in analytics. Most importantly, academics and consultants added copious tools for assessing markets, gauging corporate resources and dealing with external and internal stakeholders. In the process, sectors became “clusters,” competition “the value-web,” and fresh thinking the source of “reengineering.” Notably, everything became “strategic.” But what made it strategic?

In 2005, Jonathan Oppenheimer privately held and ran DeBeers Société Anonyme, selling an estimated 70% of the world’s total rough diamonds with a value of \$7.9bn and a reported net profit of \$554 m.<sup>4</sup> His great-grandfather, Ernest Oppenheimer, had taken over the company in 1929 and in so doing achieved a nearly complete integration of South Africa’s diamond trade. At the heart of DeBeers business was the London-based Central Selling Organization (CSO), which distributed purchased stones to handpicked sightholders, thus controlling quantities, qualities and prices. On the demand side, the DeBeers slogan “a diamond is forever” made stones an invaluable token of love not to be resold; on the supply side, the company’s stocks allowed it to flood the market whenever associated mines tried to sell direct. More recently, the diamond trade faced the end of apartheid, the fall of communism, the emergence of major Canadian competitors and NGO campaigns attacking so-called “blood” diamonds. DeBeers reacted by transferring the lion’s share of its financial assets into the Swiss-based DeBeers Centenary AG, delisting DeBeers Consolidated Mines from the Johannesburg stock exchange and selling all of its shares to three entities under significant family control. It also acquired and renewed mining contracts in Canada, Botswana, Namibia and Russia. In 2000, DeBeers began to brand its gems and a year later agreed to transfer all its retail-related rights to LVMH Moët Hennessy Louis Vuitton. Since 2002, DeBeers and its distributors have been at the core of the Kimberly Process, an intricate certification system intended to

<sup>4</sup> See EU (2007) *Investigation into the rough diamonds market*, reported January 31, 2007; Datamonitor (2006) *DeBeers – Company Profile*; and Spar, D. L., (2006) Continuity and change in the international diamond market, *Journal of Economic Perspectives*, 20(3), Summer 2006, 195–208.

eliminate “conflict diamonds” by tracing all stones from mines to retail. The process solidified supply and enhanced the quality of the brand.

This brief sketch of DeBeers integrates decisions and actions, after the facts, to present a coherent and deliberate business policy. But does it spell out the company’s strategy? Were all outcomes intended and consequences foreseen? More importantly, would the Oppenheims have done so well, if implied rationales had been widely apparent at the time decisions were taken? Could they have sustained their success? While the conventional strategy literature<sup>5</sup> refers back to the Greek *strategos* for “leader” and “military planner,” could it be that the modern connotation of the word, emphasizing uncertainty and disguise, is more instructive here? Webster’s defines “strategy” as “a plan, scheme, or trick for surprising or deceiving an enemy; . . . the skillful use of a stratagem . . . any artifice, ruse, trick devised or used to attain a goal or to gain an advantage over an adversary.” It is synonymous with “intrigue, maneuver, and contrivance.”<sup>6</sup> In fact, reviewing numerous biographies, from Jakob Fugger’s to J. P. Morgan’s, from Oppenheimer’s to Gates’s,<sup>7</sup> it seems that it is the combination of shrewdness and guile that separates the strategist from the mere rational planner and spells success in managing expectations, utilizing relations and creating and exploiting market failures. But there is a discomfort in that combination, which raises governance concerns and divides the admirers of the “go-getters” from the prosecutors of the “robber-barons.” While the former marvel at superior ability in the face of decentralized market checks, the latter insist on centrally restraining dubious behavior through rules. But in the end both controls may be lacking.

## Markets

Throughout history, competitive markets have been deemed to provide non-authoritarian social control merely based on financial sanctions. For Christian and Talmudic thinkers, competitive markets identified just prices; for French and British economic liberals, they established an individual’s freedom within and *vis-à-vis* the state. Today, the attractiveness of free markets seems to be based less on the implied working of some natural law than on the lack of regret in the face of change. Markets are seen as

<sup>5</sup> See for example Ghemawat, P., (1997) *Competition and business strategy in historical perspective*, HBS-798-010.

<sup>6</sup> Webster’s Encyclopedic Unabridged Dictionary of the English Language, Revised 1996 edn, p. 1404.

<sup>7</sup> See Heuser, U. *et al.* (eds) (2004) *Schöpfer & Zerstörer*, Rowohlt; Heller, R., (2004) *Movers and shakers*, London: Bloomsbury.

impersonal, objective promoters of efficiency and progress. Yet this confidence needs qualification.

Since the beginning of the twentieth century, perfectly competitive markets have been assumed to balance individual and common interests, stimulate an efficient allocation and use of resources, and provide a reference to detect market distortions and remedies to them.<sup>8</sup> But this concept has proved to be of limited use in formulating rules for real-life commercial behavior, assessing welfare trade-offs due to scale and technology advantages, or evaluating equity concerns and market failures.<sup>9</sup> Many questions still have no easy answers: Does competitive contracting necessarily lead to efficient contracts? When do sustainable profits reflect monopolizing behavior? Can competition spur optimal technological advances and when does it obstruct the efficiency of a naturally monopolistic supply? More recently, however, market-driven policies have been criticized for their execution rather than their conceptual base and the focus has shifted towards detecting government failures.

In 2003, EU member states converted Kyoto CO<sub>2</sub>-reduction targets into renewable obligations for their electricity suppliers; adjustments were to be market-based and facilitated by trading emissions certificates. National governments distributed EU-approved CO<sub>2</sub> allocations as allowances to companies and trading began on January 1, 2005. As planned, companies with low emissions were to profit from selling their quota while emissions above the allotted level engendered penalties; in addition, excess polluters had to surrender allowances in the second year to compensate for overshooting in the first. And yet, although prices for CO<sub>2</sub> allowances rose from an initial \$8 per ton to around \$30 per ton after six months of trading, they did so in part only because the EU Commission rejected plans by some member states to run over their allocations. Also, while early 2006 prices created incentives for using existing fuel mixes in cleaner and more efficient ways, they were too low to avoid subsidizing the switch towards renewables such as onshore or offshore wind or photovoltaic energy. Considering both remarks, observers doubted whether political authorities, at national or EU level, could in fact be relied upon, or even expected, to properly frame the market and capture the true benefits of avoided CO<sub>2</sub> pollution.<sup>10</sup>

Hence, while in a “perfect” market, actual or potential competition would effectively annul any lasting benefit of strategic behavior, so-called

<sup>8</sup> See Knight, F. N., (1921) *Risk, uncertainty and profit?* Boston: Houghton Mifflin pp. 51–6.

<sup>9</sup> See Scraffa, P., (1926) The laws of return under competitive conditions, *Economic Journal*, 36, 535–50.

<sup>10</sup> See Bockamp, S., Kruhl, J., (2007) Emissions trading – challenge for utilities. In R. Boscheck (ed.) (2007) *Energy futures*, New York: Palgrave Macmillan, pp. 273–86.

non-economic objectives, ill-determined property rights, distortions in entry or other conditions may call for regulatory intervention to replace market coordination or create “as if competition” outcomes. But real-life policy makers and regulators, far from acting as benevolent guardians, may also be driven by self-interest and the desire to avoid market and non-market controls.<sup>11</sup> Thus, the question is how to regulate the regulator and govern the government?

### Governance

“Governance” defines the rules and institutions for coordinating collective activity and the process for deriving these. As such it reaches beyond mere market-based and governmental controls and involves a host of public and private actors in setting agendas, creating rules and monitoring and enforcing compliance. Given that at each level, strategies and alternative approaches affect the process and outcome of coordination, any form of governance inherently poses legitimacy and efficiency concerns.

In democracies, for instance, public rules are seen to reflect either the will of citizens directly, or its interpretation through legislators and courts. Yet, outside of an ideal “committee democracy”, relying on the direct initiation of debate and direct votes on single issues, the question is who may instigate the process of setting or developing norms, who is involved in pre-screening rules and in making the final selection and how does one know? Also, if rules need to fit a variety of circumstances and yet be simply and certainly enforced, moving norm-setting, monitoring and enforcement authority closest to the issue at stake may improve the adequacy and efficiency of regulation but at the price of heightened legitimacy concerns. In the extreme, “private ordering” based on privately set and enforced norms, even if perfectly acceptable to contract parties, may appear to be incompatible with given public rules and unrelated to any abstract citizen-will.

And yet, real-life economic, political and social governance by necessity relies on the interaction of public and private rules and enforcement: for example, by the time that simplified competition laws, set to maintain uniformity, centralized control and legal certainty, are seen to distort commercial behavior, multiple standards and interpretations (re)-emerge, coexist and compete, until, at some stage increased complexity triggers the return to harmonized rules and centralized enforcement. In the process, private parties

<sup>11</sup> For an early discussion see Downs, A., (1957) *An economic theory of democracy*, New York: Harper & Row.

change from meeting regulatory defaults to self-regulation and back. Next, economic regulation usually involves regulatory commissions addressing other regulators, industry associations, public-interest groups, firms, particular members of management teams and other parties. *Also*, non-governmental organizations (NGOs) may be granted information and negotiation status to expose regulatory inadequacies or to assume regulatory powers and directly punish corporate non-compliance.

These interactions are not only constantly in flux, but, far from clear cut, are often suspected to be driven by strategic interests. As blunt, central norms are replaced by decentralized forms of self-regulation, whose interest is ultimately being served? How does one, from the outside, know that a regulator's moderation to induce private cooperation in fact is not a symptom of corruption? How can one ensure that an NGO does not side with the political authority whose work it is charged to supervise? When are proposals to co-regulate earnest and when are they merely self-serving? When and how is one to argue for a complete regulatory overhaul?

While in the US and EU, centralized drug authorization has been reformed to speed products to market, decentralized cost containment practices continue to delay patients' access to vital cures; proposals by the pharmaceutical industry to be involved in co-regulation, however have met with suspicion. In brief, US federal law does not regulate drug prices but requires pharmaceutical companies to quote the "best terms" offered to any health plan to the federal Medicare and Medicaid programs. Hence, to sell to the public market, pharmaceutical suppliers need to be listed in the formularies of several private health plans. The European situation is similar and yet more complicated. Approval procedures are harmonized at EMEA level but decentrally applied; reimbursement processes differ from country to country, re-imports provide a market check. Reimbursement decisions in France, for example, emerge from a highly complex interplay between the French Ministry of Health and Social Insurance, the High Authority of Health, the Transparency Commission, and the Pricing Committee. Complexities are such that drug producers increasingly shy away from selecting European countries as first launch markets – put differently Europeans typically have to wait for lifesaving medicines already available in the US.<sup>12</sup>

<sup>12</sup> While in the 1990s, 46% of first launches took place in the US, none was attempted in France; 2½ years after their first launch, 85% of all drugs were available in the USA; compared with 55% in France. See Danzon, P. *et al.* (2005) The impact of price regulation on the launch delay of new drugs – evidence from twenty-five major markets in the 1990s, *Health Economics*, 4(3), 147–51.



Addressing these concerns, representatives of the pharmaceutical industry recently suggested joining forces with health authorities in a “Global Health Union.” Its purpose was to create transparency on reimbursement standards and levels of healthcare provision; establish directives for committing fixed shares of GNP for healthcare purposes; formalize the structure of global drug development and market introduction, and regulate the speed of generic competition by disease area.<sup>13</sup>

Yet critics, wondering why society would want to hand a blank check to any industry, were concerned that substituting negotiation for market-testing healthcare costs effectively played into the hands of drug suppliers. They pointed out that the pharmaceutical industry, focusing on institutional access, next to quality, safety and efficacy, as the “fourth hurdle” to commercial success, maintains a sophisticated practice of public affairs advocacy. Its purpose is to influence governing bodies directly or by way of key opinion leaders such as healthcare professionals, patient advocacy groups, the media and the courts. Since 2001, no other US industry is estimated to have spent more money to sway state and federal public policy.<sup>14</sup> Politicians, who are understood to react to high-profile issues such as drug pricing and availability, are being targeted in states with large numbers of networked patients and in those areas of disease most feared by the general public. The media are provided with information that arouses emotions such as national pride, sympathy for minorities and anger about disability discrimination or perceived injustice. In 2006, a media storm covered the case of two UK breast cancer patients, unsuccessfully taking their local care providers to the European Court of Human Rights, to reverse an NHS refusal to pay for a specific drug.<sup>15</sup> Whilst critics were unable to directly “charge” the drug company in question with acting against the public interest, they pointed out that NHS funds which are spent in one area are not available to others. They also suggested that drug suppliers may react to cost containment strategies by lowering prices and gaining market share at the expense of high-price substitutes, i.e. by accepting legitimate market and regulatory controls instead of utilizing political agendas to “illicitly” further corporate interests.

But what makes the implied motifs illicit? Does public affairs advocacy inappropriately expand the “role of business?” Do suppliers require scrutiny when key buyers are market makers? Is it regulatory burden or corporate strategy that limits access to vital cure? Is it the seller’s price or the buyer’s

<sup>13</sup> See SIMI MBS, MCA 2.   <sup>14</sup> See [www.publicintegrity.org](http://www.publicintegrity.org).

<sup>15</sup> See <http://news.bbc.co.uk/1/hi/england/kent/4751471.stm>.

unwillingness to pay that should be reviewed? Which criteria should be used and with whose benefit in mind? Beset by the complex interactions between markets, strategies and regulatory concerns, observers typically respond to uncertainties about governance by requiring additional checks and balances. It must be a fundamental trait of guardianship to address distrust with more and more layers of control. But the question is how are the layers to be structured and interact? And is this the best one can do?

### **In sum**

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This section provided a first and fairly sketchy assessment of the notions of strategy, market and governance. Perfectly competitive markets eliminate the need for any managerial intervention and the likelihood of any strategic move. Failing market coordination, however, calls for intervention to optimize allocation and production decisions, suppress illicit acts, or attain non-market objectives. Yet by substituting or complementing the “invisible hand” of the market by the “visible hand” of some private or public actor, the pursuit of self-interest becomes cunning, rational market participants transform into strategists and Aristotle’s benevolent political man, interested in coordinating life with others, turns Machiavellian in shrewd pursuit of power. Under these conditions, the inability to fully control strategic drives of any party unavoidably generates deep-rooted distrust and layers of control. This is the subject of institutional economics which is discussed next to derive a general framework of analysis.

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## **2. The economics of distrust – market failures and institutional responses**

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Institutional economists reject the notion that the model of perfect competition is able to reduce the complexities of societal regulation to issues of mere market allocation. Instead their research provides rich but largely disconnected perspectives on the formation, structure, and economic impact of various real-life institutions of governance. Integrating some of their findings,<sup>16</sup> this section outlines an abstract reference for discussing coordination issues that range from intra- and inter-company contracting to the regulation

<sup>16</sup> For a detailed discussion see Boscheck, R., (2002) *Market drive and governance*, London: Routledge, Chapter 1, pp. 6–25.