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The 'dangerous obsession' with *cost* competitiveness . . . and the not so dangerous obsession with competitiveness

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Judging solely by the continued prevalence of the term in policy-makers' discourse, Paul Krugman's now famous warnings as to the 'dangerous obsession' of competitiveness have fallen on deaf ears. In this paper I argue that this is, at least in part, because policy-makers (as distinct, perhaps, from business school gurus) never understood competitiveness in quite the manner he assumed. I suggest that Krugman largely misdiagnosed the problem of competitiveness, directing us to the link between competitiveness and protectionism that was always less prevalent and more tenuous than he imagined. As a consequence he overlooked other more pertinent and problematic aspects of the discourse of competitiveness that persist relatively unchallenged in spite of his warnings. More specifically, I seek to show that Krugman's understanding of competitiveness is insufficiently differentiated and rests on inferences drawn from an overly stylised model of competition for market share in product markets that exhibit a high demand price elasticity and in which success is associated exclusively with strategies of cost containment. As I show through a series of extensions to his model, this leads him to fail to see that it is the privileging of cost competitiveness specifically, rather than the pursuit of competitiveness *per se* that is the dangerous obsession from which we most need protecting today.

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JEL classifications: F13, F16, F10

1. Introduction

Periodic refresher courses in the basic tenets of Ricardian trade theory are probably very good for policy-makers. Yet whilst Krugman's famous warnings about the dangerous obsession of competitiveness are, in this context, as relevant and important today as they have ever been, this does not make his diagnosis of the link between competitiveness discourse and protectionism unproblematic. Competitiveness can become an obsession; and, like most obsessions, it can become dangerous. But there is nothing inevitable about

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this. There may well once have been something of a tendency for policy-makers invoking the language of competitiveness to assume that the competition between national economies is akin to that between businesses for market share and, in so doing, to turn the positive-sum trade game into a zero-sum turf battle. Yet it is neither inevitable that they will conceive of competitiveness in such terms nor, insofar as they do, that they will translate such assumptions into policy in the form of the defensive protectionism Krugman anticipates. Good policy, in other words, can be woefully misinformed; just as a more realistic depiction of the terms of international trade (such as might please Krugman) is no guarantee of effective or appropriate policy choices.

In this paper, I return to Krugman's diagnosis of the potential damage inflicted by the concept of competitiveness (and, above all, the uses to which it is put by policy-makers), gauging the extent to which his warnings are still warranted over a decade and a half after they were first aired (Krugman, 1994A). In the process, I suggest that, in significant respects, those warnings were always somewhat overblown and somewhat misdirected and that, if policy makers ever appealed to the language of competitiveness in the manner to which he drew our attention, they have long since desisted from so doing. Yet this should not make us any less wary of the potential pitfalls associated with the appeal to the language of competitiveness. For, in his haste to caution against the dangers of protectionism and the link between competitiveness discourse and protectionism, Krugman may well have overlooked other, more prevalent, aspects of the contemporary obsession with competitiveness. I seek to show that, in misdiagnosing the dangerous obsession of competitiveness, Krugman drew on an insufficiently differentiated understanding, both of the process of competition itself and of the discourse of competitiveness. This, I suggest, led him to fail to recognise, and inadvertently to reinforce, a rather different and more virulent obsession of policy-makers—that with cost competitiveness. It is cost competitiveness specifically, rather than competitiveness more generally, that is the dangerous obsession today.

In the process I suggest that it is credible to think that Krugman's warnings as to the dangers of competitiveness discourse have indeed proved influential in policy-making circles. For, whether in response to Krugman's warnings or not, there has undoubtedly been a cleansing of any lingering protectionist connotations and zero-sum trade assumptions from such discourse in recent years. It is certainly the case today that competitiveness discourse is invariably invoked in a market-conforming rather than a market-shaping manner—a prelude for the elimination of barriers to trade rather than a justification for intervention. But this, as I seek to show, does not make it any less problematic. Indeed, somewhat ironically, contemporary competitiveness discourse seems to draw its assumptions about trade from precisely the same stylised Ricardian model that is the basis of Krugman's critique of competitiveness discourse. This, as I seek to show, leads it to a rather different set of fallacies about competition which Krugman fails to anticipate and from whose consequences he fails to protect us. The most significant and the most problematic of these, as I seek to show, is the assumption that the key to comparative advantage (and hence competitive success under open economy conditions) is cost containment. In the final section of this paper I show how virulent such a conception now is and how much damage it can do by examining in some detail the cost competitiveness discourse that underpins the EU's service liberalisation agenda (for a similar account of the EU's stance in the Doha Development Round, see Hay 2007A; see also Young 2007).

The argument is developed through a series of revisions to, and extensions of, Krugman's stylised depiction of the trade game—to goods traded less on the basis of cost than quality, to scenarios in which the full employment assumption does not hold, to markets that are less demand price elastic, and to trade in services. The analysis is illustrated throughout by reference to the place of competitiveness concerns in the EU's trade and services liberalisation agenda. It proceeds in three sections. In the first of these I return to the potential pitfalls and dangers that authors like Krugman see as inherent in the appeal to the concept of competitiveness, examining in depth the stylised model of trade on which he builds his case. In the second section, I revise and extend Krugman's model to consider trade in more complex (status) goods, such as wine and cars, which are neither traded solely on the basis of their cost nor so demand price elastic, and by reconsidering the case for intervention in contexts of unemployment. In so doing, I expose the dangers of an undifferentiated conception of competition for market share, of a failure to consider the business cycle, and of viewing the process of competition in all markets as analogous to that pertaining in markets for standardised goods (such as wool or grain). In the final section I explore the implications of this for our understanding of competitiveness in services markets, which tend to be highly labour-intensive, not especially price sensitive and highly demand price inelastic.

2. The dangerous obsession with cost competitiveness

Krugman is undoubtedly, and rightly, famous for his intemperate berating of professional politicians (who probably do not know any better) and their advisors (who probably ought to) for their most basic misappropriation of the concept of competitiveness and the misunderstanding of Ricardian trade theory that it indicates. Yet if—as one might be forgiven for thinking it should be—his intervention is assessed in terms of the extent to which the concept of competitiveness has been excised from the lexicon of public policy, then it can scarcely be judged an unqualified success. For, in the 15 years that have passed since his seminal series of articles in *Foreign Affairs* (Krugman, 1994A, 1994B, 1994C; see also 1996), the public appeal to the discourse of competitiveness has, if anything, only intensified.

Yet it is nonetheless credible to think that Krugman's warnings have not fallen on deaf ears. For, although the language of competitiveness persists, arguably the content of such competitiveness discourse has changed quite profoundly in the intervening period of time. To see this, it is important to remind ourselves of the initial target of Krugman's assault on the misappropriation of the concept of competitiveness. Tellingly, this was not Ronald Reagan (and his advisors), whose *Presidential Commission on Industrial Competitiveness* still provides the standard definition of the term amongst policy-makers (Committee on Banking, Finance and Urban Affairs, 1985), but Jacques Delors.

Delors' offending remarks related to his diagnosis of the then European affliction as arising from 'a lack of competitiveness with the United States and Japan', the proposed solution a 'programme of investment in infrastructure and high technology' (Krugman, 1994A, p. 4). And what concerned Krugman about such remarks was not so much the diagnosis of the affliction that they offered but the solution they proposed. For this, according to Krugman, indicated a profound failure to appreciate the basics of the Ricardian theory of trade—a failure intimately associated with, and directly attributed by Krugman to, the very concept of competitiveness itself and the zero-sum conception of trade between nations on which he suggested it rests. Within the terms of (his preferred) Ricardian trade theory, trade between nations is not a zero-sum game but a positive-sum game—that is, so long as nations (and their leaders) do not come to see themselves as in competition with one another for market share. For in the absence of protectionist interventions (such as the public programmes of investment in infrastructure and high technology to which Delors was pointing), free trade allows nations to specialise in the production of those goods for which they enjoy a genuine comparative advantage, with the effect that all goods are produced more efficiently than they would otherwise be. In the context of such a framework, any and all interventions designed to translate a comparative disadvantage into a competitive advantage distort the terms of trade. Thus, even in the absence of retaliatory measures, they can only result in less efficient outcomes for all concerned. From Krugman's perspective all such interventions are trade-diverting protectionist distortions from which we can only suffer. That at least was the burden of his argument in 1994.

In the current context, two aspects of this are particularly interesting. First, Krugman nowhere shows that Delors' proposed solution to Europe's competitive challenge rests on the assumptions to which he directs our attention. And the point is that, as we shall see presently, it is perfectly possible to reach precisely the same conclusions as Delors about the need to stimulate investment in core export-oriented sectors from within an (admittedly augmented) Ricardian framework that conceives of (free) trade as a positive-sum game (see also Kitson and Michie, 1995).[1] From what little Krugman actually says on the subject, it is not at all clear that it is Delors' identification of a lack of competitiveness specifically that leads him to an emphasis on the need for investment in infrastructure and high technology; far less that such a policy prescription rests on a false zero-sum conception of international trade. Krugman shows only that Delors describes the European condition in terms of a lack of competitiveness and presents, as a potential solution, a programme of investment. He assumes these to be linked directly such that the latter policy prescription is only made possible by the framing of the former diagnosis in terms of competitiveness. And he assumes, moreover, that by invoking the concept of competitiveness, Delors is committing himself to a conception of trade that is zero-sum—in which economies compete for market share in a manner analogous to corporations. This is doubly presumptive and it leads to three significant errors of omission within Krugman's argument:

- He fails to show how the zero-sum conception of trade, which he attributes to Delors (and which, by extension, might be attributed to others giving voice to a similar view today), leads him to this particular policy prescription;
- He fails to show that Delors' conception of competitiveness either rests on the problematic analogy with corporate competition or is predicated logically upon a zero-sum conception of trade; and
- Largely as a consequence, he fails to show that Delors' policy prescriptions are misguided.

In fact he shows little more than that Delors appeals (at least in passing) to the notion of competitiveness and that he reaches a different assessment of how Europe should respond

[1] Indeed, Krugman pretty much concedes the point, if not perhaps its implications, in his subsequent reflections on the subject (see, especially, Krugman, 1996, pp. 19–20, 21–23). Yet even in these later writings his ultimate position remains the same—that we simply cannot afford to sanction such trade-distorting interventions (even where they can be justified to economic sophisticates like himself under certain specific conditions) since to do so is likely to be taken as carte blanche by our (economically illiterate) political elites to engage in protectionism (see, again, Krugman, 1996, p. 24). This, it need hardly be pointed out, is an argument based not on economic theory but a rather pessimist (if widely-shared) judgement of the cognitive capacities of political elites.

to a seeming decline in competitiveness in key export markets to that preferred by Krugman. This is an important point. It suggests that Delors may in fact have been an unfortunate target for Krugman's assault—for there is no evidence, either in the speech that Krugman analyses nor in the analysis of that speech which he offers, of the offending conception of competitiveness. Indeed, this, I suggest, is indicative of a more general problem. Krugman tars any and all reference to the concept of national (or, as here, European) competitiveness with the same brush—adopting, in the process, an insufficiently differentiated view of both policy-makers' appeal to the language of competitiveness and to the potential uses to which the term might be put.

Indeed, there is a certain irony here. For whether in response to, independently of, or despite Krugman's interventions, European policy-makers today simply do not appeal to the concept of competitiveness in the way he assumes—and which he sees as integral to the internal grammar of the concept itself. Competitiveness discourse in Europe today, as is perhaps most clearly seen in the EU's services liberalisation agenda, is profoundly anti-protectionist, repeatedly pointing to the gains to be had from the elimination of barriers to trade and the cross-border provision of services. To the extent that it ever was associated with a zero-sum conception of trade and with the defence (on whatever basis) of trade-distorting interventions, it is no longer—and, as such, it is fully consistent with, and arguably even arises directly out of, the same Ricardian theory of trade that Krugman promotes.

Of course, this is unlikely to make Krugman fully comfortable with the use to which the term is put today. For a core part of his critique of the concept is that it is wrong to see economies (whether local, regional, national or continental), unlike businesses, as meaningfully in competition with one another for market share (Krugman, 1994A, p. 30). The analogy, he suggests, is a poor one and a misleading one. But the point is that if contemporary political appeals to the concept are indicative of anything, it is that policy-makers are no longer being misled by the concept in the way Krugman saw as inevitable in 1994. Were this accepted by Krugman, he would, presumably, see the concept as no longer posing a policy risk. Competitiveness would, in other words, no longer represent a dangerous obsession—just a rather unfortunate and potentially misleading, if innocent, analogy. Yet the argument of the present paper is that this too is wrong. For, as I seek to show, the assumptions that appear to underpin the contemporary appeal to the concept of competitiveness, assumptions it seems drawn from Krugman's own preferred approach to trade theory, are no less problematic and are responsible for a new and equally dangerous obsession—not with competitiveness *per se* but with cost competitiveness. To see why it is instructive to explore Krugman's argument in further detail; and to do this it is useful to examine the stylised Ricardian model he builds to show the positive-sum character of the trade game (see Krugman, 1991, pp. 93–95).

3. Interrogating Krugman's stylised trade game

In his highly stylised depiction of the trade game, Krugman invites us to imagine a world economic system comprised of only two trading economies, A and B. These economies, for the sake of simplicity and clarity of exposition, produce merely two commodities for trade—grain and cars. Imagine, further, that A is more productive than B in both commodities, but more decisively so in the manufacture of cars than grain. The model is summarised in Table 1, within which A might be said to enjoy an absolute advantage over B in the production of both goods.

Table 1. *Krugman's stylised trade game*

Country	Productivity index (units per labourer week)	
	Cars	Grain
A	4	3
B	1	2

Clearly, in order for there to be any basis for trade between these hypothetical countries, wages in country B must be lower than those in country A to compensate for A's absolute advantage. Indeed, the wages in country A must be at least 1.5 times those of country B in order for it not to be more efficient simply to produce both goods in the former country. Conversely, if wages in country A are more than four times those of country B, then it is simply more efficient to produce both goods in the latter country. Let us assume, then, that wages in country A are twice those in country B.

The unit cost of production is given by the cost of a labourer week divided by the number of units produced per labourer week. As can be seen in Table 2, under these conditions country A enjoys a comparative advantage over country B in the manufacture of cars; whilst country B enjoys a comparative advantage over country A in the production of grain (since the respective unit cost of production is less than that of their sole competitor).

Consequently, in the absence of tariff or non-tariff barriers to trade between A and B, A will specialise in the manufacture of cars, whereas B will specialise in the production of grain. If we assume that productivity levels and labour costs are fixed, then this is the most efficient outcome attainable—each economy specialises in what it can produce most effectively. Note that, within the terms of the model, this is advantageous to both A and B. Through trade, A can purchase a unit of grain for a unit of cars, thereby reducing the effective amount of labour required to produce a unit of grain from one third of a week to a quarter of a week. Similarly, through trade, B can purchase a unit of cars for a unit of grain, with an efficiency gain per unit of cars of ($1 - 0.5 = 0.5$) of a labourer week.

Trade, in such a simple model, is a positive-sum game (since, with it, fewer labourer hours are required to produce a given level of output). Moreover, if demand in country A is buoyant and country B has the excess capacity to meet that demand, then its economy will grow. The likely scenario is that demand in country B will also grow and that, all other relevant factors being equal, both A and B will enjoy a period of relative prosperity. A and B's fortunes are, then, clearly linked; unlike the competition between corporations for market share, one need not gain at the expense of the other. When A does well, B is likely to do well. Conversely, any recession A endures is likely to prove contagious.

Now, consider what happens if there is a change in the governing economic paradigm in country B, with the election of a dispositionally more protectionist administration, concerned in particular with the damage inflicted on the domestic car industry by the opening of the market to international competition by its predecessor. In fact, to be more consistent to Krugman, whose basic model we are here extending, we should perhaps make this the election of a new administration animated by considerations of national competitiveness and prone, as a consequence, to view the question of competition as a struggle to maximise global market share. Either way, anxious to restore the

Table 2. *Comparative advantage in Krugman's stylised trade game*

Country	Unit cost of production	
	Cars	Grain
A	2/4 = **0.5**	2/3 = 0.67
B	1/1 = 1	1/2 = **0.5**

competitiveness of the domestic car industry, policy-makers in B impose a punitive level of duty on imported cars.[2]

Things now look rather better for B, at least from the perspective of the new administration, but only so long as this situation proves sustainable. B now enjoys a competitive advantage (however temporary this may prove) in the international market for both goods, despite enjoying a comparative advantage in the market for grain alone. Yet note that by distorting the terms of trade—ostensibly in its favour—each unit of cars that its consumers purchase is now the product of a full labourer week where previously it could be had for half a labourer week. Trade diversion (the distortion of the prevailing terms of trade such that less total trade arises) brings a loss of efficiency. It is at least credible to think that this might seem like a price worth paying for the resulting balance of trade surplus, but Krugman's point is that such a surplus is only likely to prove temporary.

For policy-makers in country A cannot fail to notice the significant and unilaterally imposed worsening of the terms of trade between themselves and country B. And having done so, they will surely retaliate. At minimum, they are likely to impose equally punitive import duties on cars. But since cars manufactured in B do not enjoy a competitive advantage in A, this will make little or no difference. It will certainly do nothing to restore the export market on which A's domestic car industry may well have come to rely, nor the country's aggregate balance of trade position. Altogether more likely, then, is that A will escalate the developing trade war between the two, imposing equivalently punitive import duties on grain from country B. At a stroke, the latter's comparative advantage will be turned into a competitive disadvantage. The efficiency gains arising from trade (as well as the associated externalities for the economy) are now threatened as all imports have effectively been priced out of the market by swinging import duties.

The lessons of this modern morality play could scarcely be clearer. Yet even as hypothetical examples go, this is an extreme one. Although Krugman does not follow the example through to its logical conclusion (as above), he undoubtedly sees it as providing a cautionary tale as to the dangers of the narrow promotion of competitiveness in the absence of a genuine comparative advantage. The moral is that protectionism, however well intentioned, can only end badly for all parties—and that such protectionism is only made more likely by the (inherently parochial) concern to defend national competitiveness.

But much of this follows from the way in which the model is set up in the first place. To see how, consider the addition of a further commodity—say, wine—to the scenario thus far developed.

[2] If relative productivity and labour costs remain constant, then the level of duty must exceed 100% in order for B's comparative disadvantage to be translated into a competitive advantage in this way.

3.1 Can trade-diverting measures ever be justified?

3.1.1 Extension I: the problem of variable comparative advantage. Again, let us assume that A enjoys an absolute advantage over B in that it can produce a unit of wine (of a given quality) for less of an investment in labour time and resource. Indeed, let's assume that A's productivity index is slightly more than twice that of B. Let us also assume that the cost of labour in country A is twice that in country B (Table 3).

In this scenario, A enjoys a comparative and, indeed, a competitive advantage over B.[3] But that advantage is slight. As a consequence, its favourable competitive position is highly sensitive to small fluctuations in relative productivity, relative labour costs and, of course, to the terms of bilateral trade. Such a comparative advantage may well also be highly sensitive to climatic variations from one vintage to the next. It might be, for instance, that the weather is rather more reliable in country A than country B. In a good year B will typically enjoy a comparative advantage over A; in a poor year (like this) the tables are reversed. Thus, whilst A presently enjoys a comparative advantage over B, there is no guarantee that this will survive the next vintage.

This is a rather more interesting and arguably rather more plausible example. Anxieties about international competitiveness often present themselves to policy-makers in a form not unlike that confronting the government of country B in this scenario (on the EU's handling of such issues in the wine market see, e.g., Carter and Smith, 2008). So what should it do? And might similarly cautionary lessons about the dangers of competitiveness-enhancing subsidies and trade distorting measures to those drawn above be inferred from a consideration of this revised scenario? Arguably not—or at least not so simply.

What is clear is that any distortion of the terms of trade between A and B will inevitably result in some loss of the potential efficiency gains to be had from free trade—and in this regard, at least, Krugman is entirely correct. Yet it may nonetheless still be rational for the government of B in this scenario to forego some such efficiency gains for other economic, social and political ends. Moreover, it may do so in a quite conscious and deliberate effort to defend the competitiveness of its wine producers and in full knowledge of the inevitable losses in efficiency that will result. Rather like Delors in 1993, the appeal to the concept of competitiveness need not necessarily signal ignorance to the potential efficiency gains to be had through free trade—just a willingness to forego some of these potential gains under certain conditions.

So how might this work? Concerned about the vagaries of the climate and its implications for domestic producers in a highly (cost) competitive market, the

Table 3. *Krugman's stylised trade game - a first extension*

Country	Productivity index	Unit labour cost	Cost per unit of wine
A	2.1	2	2/2.1 = **0.95**
B	1	1	1/1 = **1.00**

[3] Since there are no distortions in the 'natural' terms of trade, the competitive and comparative advantages are identical.

government in country B might well choose to offer its wine producers compensation, in the form of direct subsidies, for each poor harvest. The effect, though perhaps more palatable to its partners in an ongoing international dialogue about the terms of trade, is much the same as imposing a vintage-specific tariff on wine imports. For it is both trade distorting and trade diverting. And, perhaps more significantly, it is likely to prompt retaliatory measures—either in the form of equivalent subsidies to wine producers in A or modest import duties on wines from B. Yet, this notwithstanding, and especially if A and B can reach some mutual understanding about the conditions under which such vintage-specific subsidies might be deemed appropriate, their principal effect is to shore up the domestic market—in effect, by restoring the competitive advantage of domestic producers in the home market. Their effect will undoubtedly be to suppress potential levels of trade in wine. Yet, whilst some of the efficiency gains of free trade are certainly lost, those efficiency gains which remain are likely to be more evenly and stably distributed between A and B, with the effect that both domestic industries are stabilised, jobs secured, and the need for significant and costly structural economic reform (a re-specialisation in the production of cars or grain) deferred. The point is that there is an inevitable trade-off here between maximising the efficiency gains of trade and stabilising the domestic economy. Subsidies and/or import duties can be an effective and rational instrument in managing that trade-off.

At this point it might well be objected that, in his later reflections on the topic, Krugman in effect concedes the point. In his 1996 article in the *Oxford Review of Economic Policy*, for instance, he presents the 'strategic trade' perspective, which he associates with much of the new trade theory as a more sophisticated development of the kind of Ricardian classicism that clearly informs his more public assault on the concept of competitiveness. Significantly, he concedes that 'there is more to life and even to international trade than comparative advantage' (Krugman, 1996, p. 21), and that under certain specific conditions (perhaps even those pertaining in the above example) the case for protection and certainly intervention is a good one. Yet what he gives with the one hand he takes away with the other. For, despite conceding a place for strategic intervention within a positive-sum theory of trade, he goes on to argue that such a case for selective protection should not be made publicly—since our 'mercantilist' political elites (who are either too stupid, too intransigent or both) will take it as an excuse for the kind of universal protectionism to which he sees them as inexorably drawn. This is an amazingly defeatist position for a public intellectual of his standing to adopt—especially since his self-declared 'cynicism' stands in some marked tension to the seeming reticence today of political elites to invoke a competitiveness defence for strategic trade policy.

But what it does perhaps serve to do is to point to the risks inherent in managing the trade-off between the potential efficiency gains associated with liberalisation and the stabilisation of the domestic economy that we might associate with strategic trade policy. For, in the absence of a bilateral or, preferably, multilateral agreement between states as to the circumstances under which, say, compensation to farmers for a poor vintage are to be allowed (and the appropriate levels of such subsidies), there is a clear danger that unilateral action will lead to retaliation and an escalating trade war. Yet, precisely because of the potentially considerable efficiency gains at stake here, there is every likelihood that a solution to this collective action problem can be found (in the form of a bilateral or multilateral agreement governing the appropriate use of subsidies and compensation). To give up on the very possibility of such a solution and others like it (the best case scenario) simply by appealing to the limited cognitive capacities of political elites seems unnecessarily defeatist and surely calls into question the public value—and perhaps the point—of trade theory itself.[4]

3.1.2 Extension II: the missing macroeconomic perspective. A second extension of Krugman's basic model reinforces many of the above observations. It draws more clearly on the existing literature (especially Kitson and Michie, 1995) and can be dealt with, largely as a consequence, rather more rapidly. Its aim is to inject at least a dose of macroeconomic realism into the stylised trade game that Krugman presents. The point is a simple one. If we revise the full employment assumption of standard trade theory and accept the possibility of variations in levels of sector-specific employment across the business cycle, then the case for interventionist strategic trade policy is significantly recast. Thus, perhaps in the context of a global recession and an associated global squeeze in demand, key export-oriented sectors of the economy find either that they lose market share (since the high value-added goods they supply at the upper end of the market are disproportionately affected by falling demand) or retain market share in a diminishing market, there may well be a strong case for at least temporary protection. If trade-distorting subsidies and/or the raising of existing tariff barriers are likely to make the difference between steady employment within the sector such as might make possible the prospect of benefiting from an anticipated global resumption in growth, on the one hand, and mass redundancies and the associated loss of capacity in what was once a key export-oriented sector on the other, then the domestic case for intervention is likely to be an exceptionally good one. Moreover, and more significantly, such intervention need not be—and in fact is very unlikely to prove—'beggar thy neighbour'. For the employment protected both immediately and in the future must itself be seen as a source of demand—demand that may well contribute to the holding up of trade levels and which would simply not be there in the absence of an interventionist strategic trade policy.

3.2 Cost and quality competitiveness

3.2.1 Extension III: from competition in standard goods to competition in status goods. This is all very well, and it certainly suggests that considerations of competitiveness—even those leading to trade-diverting subsidies or import restrictions—need not be animated by a zero-sum conception of trade. It shows, in effect, that *competitiveness need not necessarily be a dangerous obsession*. Yet, whilst sharpening our analytical purchase on certain issues, stylised models such as those thus far considered inevitably divert our attention from others. Indeed, vital for the analysis that follows is one factor completely overlooked in these models and in Krugman's analysis more generally. Ricardian trade theory, new or

[4] Interestingly, it seems, Krugman has started to revisit these issues once again in his most recent popular writings. Particularly illuminating, though at the same time perplexing, here is a recent op-ed in the *New York Times* (31 December 2009). Prompted perhaps by Samuelson's (2004) demonstration that mercantilist protectionism may, under certain conditions, prove damaging only to other economies, Krugman attributes the loss of an estimated 1.4 million US jobs to Chinese 'exchange rate protectionism' (the undervaluation of the renminbi). In so doing he not only engages in precisely the kind of 'back-of-an-envelope' calculation for which he berated Lester Thurow in attributing US job losses in the 1990s to Japan's newfound competitiveness (Krugman, 1994A, p. 11), but also gets perilously close to advocating retaliatory protectionism—as much of the online commentary on his piece points out. Quite where this leaves Krugman's account of the dangerous obsession of competitiveness is an interesting question—but it would certainly seem to suggest the value of a systematic reappraisal of the initial argument in the light of such significant concessions.

old, tends to assume that consumers are motivated to purchase a good (or service) principally—indeed, in the models we have thus far considered, exclusively—on the basis of its price.[5] Competitiveness, insofar as we are safe to use the term, is an index of the degree to which a business (or economy more broadly) can bring a given good (or service) to market for less.

Thus, in the above models it is assumed that the goods produced in countries A and B are entirely interchangeable—once their respective price tickets have been removed, the consumer cannot tell them apart. To the extent that this assumption holds, the rational consumer will indeed select his or her purchases solely on the basis of price. Clearly, however, some goods—grain might be a good example—are more readily interchangeable in this way than others. These goods are typically referred to as standard goods (Aspers, 2009; Beckert, 2009). Markets for such goods are more price sensitive; and they may tend also to exhibit a greater price elasticity of demand (with a stronger inverse correlation between price and demand). Yet it would be strange indeed to suggest that the markets for cars or wine operate in an analogous fashion. For these are typically seen as status goods (Podolny, 1993; Aspers, 2009; Beckert, 2009; on the increasingly hybrid character of the market for fine wine, see Hay, 2010). Indeed, given Krugman's proclivity for pointing to the dangers of inappropriate analogies, it is strange that he overlooks the potential problems of assuming all markets for goods and services to be analogous to that for grain.[6] It is the central argument of this paper that it is precisely *this* inappropriate analogy—rather than that between nations and corporations—that is responsible for today's dangerous obsession with cost competitiveness.[7]

Consider again the market for wine. Whilst many consumers might find it difficult to distinguish reliably between an (unlabelled) glass of claret and one of Californian cabernet sauvignon, it would be ridiculous to suggest that at the point of purchase these wines are essentially interchangeable. No less ridiculous is the suggestion that consumers' preferences for one over the other at the point of purchase are informed exclusively, or even significantly, by their relative price. Indeed, one might even suggest that, in many consumers' minds (whether they can tell them apart or not), Bordeaux and California produce such different styles of wine, that they are not meaningfully in competition with one another at all—Bordeaux has an effective monopoly in the production of claret, just as California has an effective monopoly in the production of, say, cabernet sauvignon from the Napa Valley. It might also be the case that the very top end of this market is characterised by an inverse price elasticity of demand—in which high prices actually boost demand since they are taken as a signal of quality, scarcity and reputation. The point is that the complex and differentiated character of the market for wine renders any analogy with that for grain highly problematic. If French producers and/or the French government are concerned with their seeming lack of competitiveness in certain parts of this market, it certainly does not follow that devising strategies to reduce prices will suffice to restore competitiveness. It may well be that it is quality—or, at least, perceived quality/reputation—rather than cost that is the key to competitiveness in this market (see Landon and Smith, 1997, 1998). In so far as this is the case, it is likely to be crucial in maintaining or enhancing competitiveness that producers are insulated from narrow cost competitiveness considerations. For, in the most price insensitive of markets, the competitiveness of

[5] We consider the extension of this to trade in services presently.
[6] In fact, Krugman's example is wool, but the point is the same.
[7] Just to be clear here, the analogy is one that Krugman repeats rather than initiates. It is not, by any means, his alone and he cannot be held responsible for its prevalence.

domestic producers is perhaps best gauged by the price consumers are prepared to pay for a commodity of a given quality. As this suggests, cost competitiveness is likely to prove highly corrosive of quality competitiveness—and, ultimately, of quality (since expensive production techniques [hand sorting of grapes and aging in new oak casks, for instance] are likely to be the first casualty of effects to reduce the price of the commodity to be traded).

In each of these respects, the market for wine is not so very different from that for cars. Indeed, any sustained reflection on the subject reveals more and more markets that are at least as quality-sensitive as they are price-sensitive. And the more quality-sensitive the good, the less the market for such a good can be said to exist to promote the efficiency gains arising from trade. For, if only California can produce Napa Valley cabernet sauvignon, there is no efficiency gain to be had from importing or exporting such a commodity. As this suggests, status goods, unlike standard goods, are traded for the additional choice to consumers that they facilitate, not for the efficiency gains arising from their trade. The point is that it is in precisely such markets that the competitiveness of most EU-European economies is principally determined. However distinctive the market for wine (and see, on this point, Combris *et al.*, 1997; Hay, 2007B, 2010), it is arguably far more indicative of the nature and complexity of the competitive challenges faced by the European economy today than that for grain.

This is an important point. For, whether the concept of competitiveness invoked by, say, European policy-makers is predicated on a zero-sum conception of trade or not, much of that discourse simply conflates competitiveness and cost competitiveness. As such, it distorts significantly the genuine problem of competitiveness that the European economy faces today.

Yet there is a need for caution even here. For whilst the assumption that all goods markets are analogous to those for grain is clearly a major distortion, particularly so for EU-European economies, there are nonetheless potential costs associated with trade-distorting interventions intended to preserve the capacity to compete on the basis of quality rather than cost. Put simply, where there are multiple sources (within a country) of commodities that compete principally in terms of quality, productivity growth will require open access to foreign markets to prevent damaging price reduction at home. Once again we are in a situation in which there are clear trade-offs between maximising the likely benefits arising from trade and preserving the capacity to compete on quality rather than cost alone. But the point is that such trade-offs are not well understood if we assume, as in standard trade theory, that all such markets are analogous to those for standard goods in which market share is solely a reflection of price.

3.2.3 Extension IV: competitiveness and the liberalisation of services markets. My argument thus far is that there is more to the potentially dangerous obsession of competitiveness than the problematic analogy between competition between nations and that between corporations for market share to which Krugman draws our attention. Indeed, rather more pertinent to the question of whether competitiveness is a dangerous obsession amongst policy-makers today, I suggest, is the common assumption in competitiveness discourse that all product and service markets are analogous to those for cheap consumer goods characterised by high demand price elasticity.

Here the European debate on the advantages of an internal market for services provides a telling example. It reveals, once again, the dangers of inappropriate market analogies drawn from the analysis of the trade of standard goods.

Named after its principal architect, the former European Commissioner for the Internal Market, Frits Bolkestein, the directive on services in the internal market (to give it its full title) was intended to reduce barriers to the direct provision of, and cross-border trade and direct investment in, services. This it sought to do by eliminating, in essence, all non-proportionate or discriminatory regulations of individual member states pertaining to the provision of services unless justified in terms of a demonstrable public interest. Particularly contentious in this regard, was the so-called 'country of origin principle'. This would have allowed service providers effectively to test the waters in other markets by providing, prior to establishment and for a limited period of time, services to customers within those markets on the basis of the laws pertaining in the service provider's country of origin. In so doing it would have allowed, the now notorious 'Polish plumber' to provide services in France under the legal conditions pertaining to the provision of services in Poland.[8]

What is interesting about this in the context of the present discussion is the underlying rationale for service liberalisation on which the Bolkestein directive was predicated. That rationale is familiar, consistent, distinctive, and, I suggest, problematic. It can be summarised in terms of a series of quotes taken from the (revised) text of the directive itself (European Parliament and Council, 2006):

- 'A competitive market for services is essential in order to promote economic growth and create jobs in the EU' (p. 3).
- 'A wide range of Internal Market barriers ... undermine the global competitiveness not only of EU service providers, but also of the EU manufacturing sector, which increasingly relies on high quality services' (p. 3).
- 'A free market which compels member states to eliminate restrictions on cross-border provision of services while at the same time increasing transparency and the information required, would give consumers wider choice and better services at lower prices' (p. 3).
- 'The [current] fragmentation of the internal market has a negative impact on the entire European economy, in particular on the competitiveness of SMEs and the movement of workers, and prevents consumers from gaining access to a greater variety of competitively priced services' (p. 4).
- 'The establishment of a genuine internal market is a matter of priority for ... improving employment and social cohesion and achieving sustainable economic growth so as to make the EU the most competitive and dynamic knowledge-based, employment-boosting economy in the world by 2010' (p. 4).
- 'Removing [internal] barriers to [trade in services] ... is a basic condition for ... reviving the European economy, particularly in terms of employment and investment' (p. 4).

[8] It is of course important to note here that the EU's service liberalisation agenda relates both to tradable and non-tradable services. Plumbing is, of course, a non-tradable service, with the Polish plumber having to cross borders in order to sell her services in another economy. Many financial and insurance services, however, are in principle tradable. The point is that service liberalisation takes a different form for tradable and non-tradable services, respectively—harmonised regulation in the case of the former, the attempt to establish the 'country of origin principle' in the latter. Limits of space prevent a detailed assessment in this paper of the implications of the tradability of services for the likely consequences of trade liberalisation. Suffice it to note that the intensification of price competition in tradable financial services that might credibly be linked to service liberalisation is likely to have contributed significantly to the exposure of the European economy to the systemic risk exposed by the global financial crisis—through the under-pricing of risk. This is a point to which I hope to return in future work. I am indebted to the comments of one of the referees for this observation.

What is immediately striking about this list is how similar its rationale is to that offered for the benefits of external trade liberalisation more generally by Krugman (1994A). Internal service market liberalisation, just like external trade liberalisation, is good for consumers and is good for competitiveness. And internal service market liberalisation is good for very similar reasons—consumers can expect to benefit from cheaper services and greater choice; the intensification of internal competition will result in increased international competitiveness (since service providers will need to show themselves to be competitive in order to survive in such a market); and the efficiency gains arising from trade liberalisation in a sector that already accounts for 77% of EU GDP (European Commission for External Trade, 2006, p. 8), will boost employment, growth and the integration of the European labour market.

Yet there are serious reasons to doubt such optimistic projections. For all of the above rests on a series of common assumptions both about the character of service markets and the competition between service providers to which they give rise. These are, at best, crude and simplistic, at worst entirely inappropriate.

So what are these assumptions? Well, they are essentially three-fold. Markets for services are assumed to be highly price-sensitive and both price and demand elastic. They are price-sensitive in that consumers are assumed to shop around and generally to choose the cheapest provider of a given service; they are price elastic in the sense that any reduction in price is assumed to result in an increase in demand; and they are demand elastic more generally in the sense that there is not assumed to be a finite demand for a given service—supply and demand co-vary (and the coefficient of co-variation is high).

The basic problem with these assumptions is that they are largely transposed from the analysis of standard product markets, though they are far from unproblematic even there. Yet even were we to accept such assumptions as entirely unproblematic for product markets, it is clear that they fail to reflect a number of key features of almost all service markets. Three in particular stand out:

- Such markets tend to be highly labour-intensive, such that the cost of a given service is likely to be related very closely to the price of labour;
- Many service markets, notably those for corporate services, but also those for legal services, are not especially price-sensitive—convenience, proximity to the site at which the service is to be provided and the reputation of the service provider are typically more significant factors in determining demand;
- Many such service markets are highly price inelastic—reducing the price for which the service is provided is likely to have little or no consequence for the volume of demand for the service, which is essentially fixed.

Of these three factors, it is the third which is arguably the most significant. For it means that markets for products and markets for services (whether price-sensitive or not) are by no means directly analogous. We cannot assume that just because heightened price competition in markets for consumer goods, for instance, may result in increased consumption, increased growth and increased employment, the same will occur in markets for services.

Yet the Services Directive rests on precisely such a supposition. So what happens to the rationale for internal service market liberalisation when one replaces the offending assumptions with more realistic ones? In short, much of its appeal disappears. Consider its impact in services markets which are price-sensitive.[9] The Services Directive, even in its revised form is, of course, designed to intensity price competition between service providers; and it is entirely realistic to think that this will be its principal effect. But the consequences of heightened cost competition are unlikely to be as benign or beneficial as the Commission assumes when it is noted that: (i) close to 70% of all EU employment is in services; (ii) service provision is labour intensive; (iii) labour costs are the principal factor determining the price of a given service; and (iv) many service markets, like those for insurance and even, perhaps, plumbing exhibit a minimal price elasticity of demand. Substitute these assumptions for those which underpin the Services Directive and an altogether different and rather more alarming prospect emerges.

That scenario looks something like this: service sector liberalisation does indeed intensify price competition, leading to a reduction in effective prices; since labour costs represent such a high proportion of the price of a service, price reductions squeeze earnings; since such a high proportion of EU employment is in the service sector, a sectoral fall in earnings is likely to translate into a significant aggregate drop in consumer demand for both goods and services; in the kind of flexible labour-market now being built in Europe, excess capacity in the service sector is likely to result in redundancies, further suppressing demand as well as driving down wages. A downward spiral is rapidly established.

This is depressing enough in itself. But, if anything, it understates the extent of the potential problem. For it fails to take account of the low price elasticity of demand that characterises many service markets. Insofar as this additional assumption is warranted, public authorities should, in fact, be striving strenuously to maintain, even to increase, the price of services in these sectors. For to encourage price competitiveness in such markets is to suppress potential GDP and, in a situation in which reductions in price are likely to be reflected in reductions in wages, to suppress potential demand. Once again, it seems, the dangers of fetishising cost competitiveness are cruelly exposed.

One further factor completes a rather sombre picture of current trends. It is demographic change. As its population ages and its birth-rates fall, Europe, as is now almost universally accepted, faces a significant worsening of its already precarious fiscal balance (see, Gros, 2005). Indeed, it is precisely for this reason that so much of the recent internal market agenda is focussed (quite rightly) on measures designed to improve employment rates amongst those of working age. But it is not just rates of employment that are important here; certainly no less significant, and arguably more so, are the aggregate levels of earnings of the working population. For it is these earnings, rather than employment levels, which ultimately determine the value of taxation revenues. In this respect the Services Directive is doubly problematic. First, if the above scenario is right, service market liberalisation is unlikely to deliver the anticipated increase in aggregate employment levels. Second, even if it were accepted that the Services Directive might provide a boost to employment levels across the EU, it is difficult to see how it could do

[9] As noted above, the rationale for the liberalisation of the internal market for services seems to proceed from the assumption that all services markets are highly price-sensitive. This is, of course, a crude exaggeration, but arguably rather less crude an exaggeration than the assumption that such markets are demand price elastic. It is nonetheless important to note that many services markets—like that, say, for fine dining—are far more quality-sensitive than they are cost-sensitive. It is tempting to see such markets as largely immune from the impact of the Services Directive. But this is too simple—for market liberalisation may well serve to increase the relative salience of price in the shaping of consumer preferences. Insofar as this is indeed the case, the assumption that all service markets are highly price-sensitive may tend to become something of a self-fulfilling prophecy.

anything else but suppress wage levels. And by holding down potential earnings in this way, it merely exacerbates Europe's problem. If the ratio of net welfare recipients to net welfare contributors is rising, then the last thing Europe can afford is a set of public policy commitments that suppress the earnings—and hence the fiscal—potential of those in employment.

Of course, the dilution of the original Bolkestein directive may well (inadvertently) have served to lessen, or at least slow, such effects somewhat. But, ultimately, there is only so much solace that one can take from a recognition that the tempering of the original directive may serve to release its deleterious effects more slowly. For the point is that the rationale for the original and revised versions of the directorate alike are predicated on a series of problematic assumptions about the character of service markets and the process of competition to which they give rise. These, as I have sought to show, are rather more intimately connected to today's discourse of competitiveness than the protectionism to which Krugman alerts us ever was. Competitiveness discourse today is not predicated on a zero-sum conception of competition between nations and is the pretext not for protectionism but the elimination of barriers to trade in a manner that Krugman would no doubt commend. But it is no less problematic for this.

4. Conclusion

What stops us from seeing this is not the dangerous obsession of competitiveness to which Krugman drew our attention in 1994, but a new and possibly yet more virulent obsession—that with cost competitiveness. Our policy-makers, it seems, have long since ceased viewing the competition between nations and, if ever they did, regions, as analogous to that between corporations—if, indeed, ever they did. But sadly, they seem yet to realise the dangers of viewing the dynamics of competition in all markets for goods and services as analogous to that for cheap consumer goods. Until such time as they do the European social model is seriously in jeopardy as cost competitiveness threatens to become not just a dangerous obsession, but a dangerously obsessive compulsion.

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