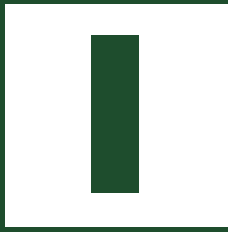


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CRACOW UNIVERSITY OF ECONOMICS  
Department of International Trade  
Centre for Strategic and International Entrepreneurship

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**CRACOW UNIVERSITY OF ECONOMICS**  
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## Foreign investment and growth: A case of selected African economies

Michael Appiah, Fanglin Li, Doreen Idan Frowne, Daniel Tetteh Donkor

### ABSTRACT

**Objective:** The purpose of the study is to indicate how foreign investment impact on economic growth in some selected African economies.

**Research Design & Methods:** The study employed the Panel ARDL (PMG) technique to estimate the impact of foreign investment proxy as FDI net inflows on Growth measured as GDP per capita.

**Findings:** The results of Panel ARDL indicate that foreign investment has a positive impact on economic growth as well as a positive sign of trade openness, inflation, and labor. The study stresses that for increasing economic growth there is a need to seek more foreign investments, increase trade openness and inflation at the same time improve upon employment conditions in selected African developing countries.

**Contribution & Value Added:** The novelty of this research is in presenting and emphasizing the significance of FDI in some selected African countries on economic growth.

**Article type:** research paper

**Keywords:** foreign investment; emerging economies; economic growth; ardl; panel data

**JEL codes:** F63, F35, C23

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### INTRODUCTION

The influence of foreign investment (FI) on growth is an area with enough investigations by many researchers around the world. Most of these researches center on developed countries while with fewer concerns on African nations. Foreign investment assumes a critical role in the improvement of the economy at large. The purpose of the study is to indicate how foreign investment impact on economic growth in some selected African economies. The study employed the Panel ARDL (PMG) technique to estimate the impact



of foreign investment proxy as FDI net inflows. Growth measured as GDP per capita. Foreign Investment is explain to take overflow effects among all divisions within the economy of the host nation such as export of goods and service increment, importing advanced technology, implementing new advanced product developments, reducing the unemployment rate by the creation of employment and increasing the financial and funds of local investors. The overflow effects could be a lot higher in a specific business setting, for example, enhanced development stock, abnormal state of human development and financial sector development (Azman-Saini, Law, & Ahmad, 2010; Herzer & Klasen, 2008).

Foreign Investment inflows in Africa have been lower measuring it with that of other regions of the world, although in recent years there was increment it is still the lowest worldwide. Drawing more FDI inflows into the region demands improvement in the business setting such as human capital development and infrastructural development to have competitive returns from the FI overflow effects (Gohou & Soumaré, 2012; Yamin & Sinkovics, 2009). The business atmosphere in African nations is insufficient, since the infrastructure, development stock, and human capital is low, making a comparison to other regions of the world. Recently, reports demonstrate 27% of African populace can access the internet, 22% of African populace are using mobile devices, transportation costs in Africa are the highest in the world and access to electrical power in Africa is of the lowest (OECD, 2015).

It is more significant to examine the entire effects of foreign investment on growth. Most studies are less focused in African countries (Almfraji, Almsafir, & Yao, 2014; Sbia, Shahbaz, & Hamdi, 2014). Studies of this nature in Africa are on the low. It has become necessary to bridge the distance within Africa by supporting policymakers in decision making as well as the introduction of an efficient policy in the growth situations. Economic growth and development can be influence by structural factors, such as foreign direct investment and trade openness; stability factors, such as inflation, and labor. The study examines the importance of these variables in affecting economic growth and development using yearly data from 1995 to 2015 and Panel ARDL methodology.

This study is organized in the following. Section 2 talks about the literature review and theory development, with Section 3 outlining the materials and methods used. Section 4 gives and discusses the findings, gives details about various checks whiles comparing the results with other studies. Finally, Section 5 deals with the conclusion.

## LITERATURE REVIEW AND THEORY DEVELOPMENT

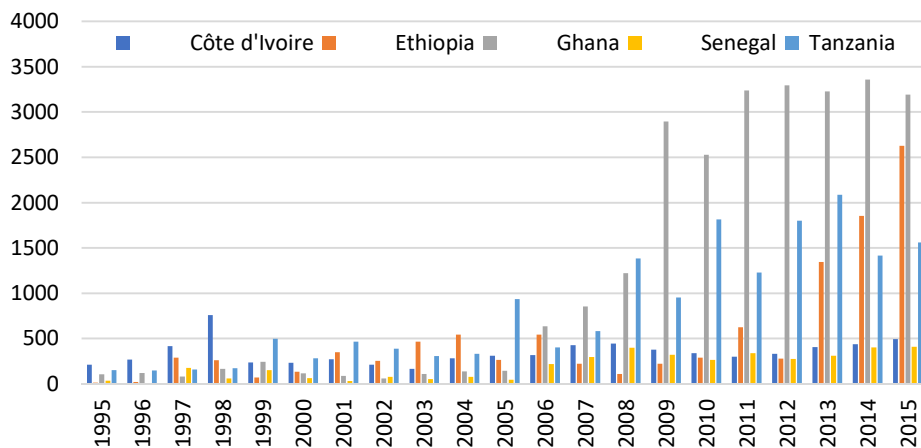
The hypothetical connection between foreign investment and growth mostly traced back to growth and dependency theories. Growth theories propose that foreign investment advances growth insisting that capital investment plays a role (Adams, 2009). The growth theories, however, stressed the transfer of technology through foreign investment. In light of the fact that developing nations need necessary infrastructure, for example, education, financial markets including political stability. (Adams, 2009; Bengoa & Sanchez-Robles, 2003) separated from technology exchange, FDI additionally goes with its hierarchical and administrative abilities, marketing knowledge and market access through networks worldwide (Adams, 2009; Balasubramanyam, Salisu, & Sapsford, 1996). Arslan, Tarba, and Larimo (2015) have contended that foreign investment plays a two-way work by adding up to capital requirements and expanding all-out total factor productivity.

Interestingly, the dependency theories propose that over-reliance on foreign investment inflows is estimated to give negative effects on growth and income dissemination in light of the fact that FDI creates monopolies in the industrial sector, which in turn leads to underutilization of residential assets (Adams, 2009; Svilokos, Vojinić, & Šuman Tolić, 2019). This infers foreigners control the economy and as opposed to growing naturally; it develops in a disarticulated manner (Browett, 1985). Thusly, the multiplier effect is feeble and prompts dormant growth in emerging nations (Adams, 2009).

Based on these theories, numerous exact investigations have been completed to look at the connection between FDI and economic growth, inter alia by (Borensztein, De Gregorio, & Lee, 1998; Campos & Kinoshita, 2002; Laura, Areendam, Sebnem, & Sayek, 2004). For instance, Zhang (2001) detailed that foreign investment stimulates growth in nations where there are low levels of infrastructural development. Balasubramanyam *et al.* (1996) presumed that the upgrading impacts of FDI are more grounded in nations where the labor force is educated and encouraging the exportation instead of importation. Campos and Kinoshita (2002) stated that foreign investment in the form of technology transfer has a positive sign of growth. Likewise, Sokhanvar (2019) guarantee that small scale level of foreign investment can impact on growth and be treated without doubt, as the greater part in this study try not to control concurrences predisposition among nations.

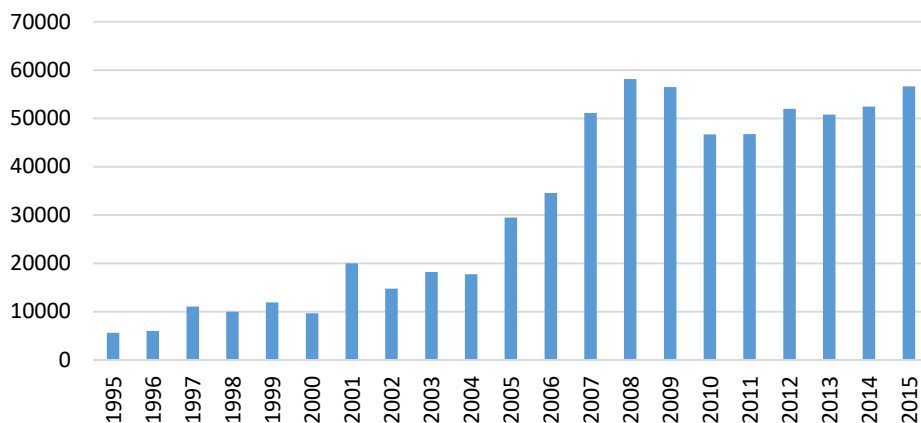
A few investigations discover the insignificant nature of foreign investment in growth, for instance, Akinlo (2004) who finds out that there is no significance between FDI and growth in Nigeria. Again Ayanwale (2007) also confirms the insignificant nature of FDI on the growth of the Nigerian economy. Hermes and Lensink (2003) inferred foreign investment applies a critical adverse impact on the host nation. Comparative outcomes by Fry (1993) who find out that FDI does not exert any significant effects on growth. Finally, Sylwester (2005) talked about the insignificant position and relationship between FDI and economic growth.

Taking into consideration the direction of causality, Basu, Chakraborty, and Reagle (2003) contends that the evacuation of credit and liquidity problems had supported foreign investment in the Latin American nations. Nair-Reichert and Weinhold (2001) contend that the causality direction relies upon beneficiary nations. De Mello Jr (1997) contends that the impact of foreign investment on growth is exceedingly varied crosswise over nations has and these variations are increasingly articulated for mostly open economies. Hence, there is a requirement for the host nation on foreign investment inflows.



**Figure 1. FDI inflows to study countries**

Source: authors computations from WDI data base. (WDI, 2018).



**Figure 2. FDI inflows to Africa Billion USD**

Source: authors computations from WDI data base. (WDI, 2018)

## MATERIAL AND METHODS

A panel data for five African countries was engaged in this study, which is taking from the World Bank Development Indicators from the period 1995 to 2015. The selected countries for this investigation are Ghana, Ethiopia, Cote D'Voire, Senegal and Tanzania based on a report by [www.africa.com](http://www.africa.com) stating them as the fastest growing economy in Africa. The variables used for this study will include GDPPC, which is Gross Domestic Product Per Capita as the dependent variable. Trade Openness (OPEN) as a proportion of export and import of gross domestic product per capita, FDI as foreign direct investment, Inflation which is proxied as the Consumer Price Index and LAB as total labor force all as explanatory variables.

**Table 1. Variable Description**

Variables	Unit/Proxy	Source
Gross Domestic Product Per Capita (GDPPC)	Current USD	World Development Indicators
Trade Openness (OPEN)	Current USD	World Development Indicators
Foreign Direct Investment (FDI)	BOP Current USD	World Development Indicators
Inflation (INF)	Percentage/Consumer Price Index	World Development Indicators
Labor (LAB)	Thousand	World Development Indicators

Source: authors computations from WDI data base. (WDI, 2018).

### Empirical model

Following the contribution of Solow (1956) in explaining growth theories, most writers identify growth-modelling variables for estimation. The accompanying variables utilized in this study include trade openness, labor, foreign direct investment, human capital, and exchange rate among others (Barro, 1995; Obadan, 2008). The growth model in this investigation is:

$$GDPPCit = \alpha_i + \beta_1 OPENit + \beta_2 FDIit + \beta_3 INFit + \beta_4 LABit + \varepsilon_t \quad (1)$$

Where *GDPPC* is the real *GDP*, *OPEN* is trade openness, *FDI* is foreign direct investment, the *INF* is inflation and *LAB* indicates total labor force,  $\varepsilon_t$  represents error term,  $\beta_1$ - $\beta_4$  are the factors to be assessed, *i* speaks of the country while *t* infers to a time period. Equation (1) states that the explanatory variables, which are trade openness (*OPEN*), foreign, direct investment (*FDI*), inflation (*INF*) and total labor force (*LAB*) influence *GDP* Per Capita.

### Panel unit root test

Levin, Lin, and Chu (LLC) approach to estimating unit root test was used in checking the stationarity of the variables. The lag selection criterion is according to the Schwarz information criterion (SIC). The unit root is estimated at both levels on a constant and at 1st difference constant.

### ARDL test for cointegration

This study will employ ARDL estimation, which is a cointegration method by Pesaran and Shin (1996), to examine the lagged values. Theoretical and empirical research focuses on the long-run relationship within the economy. Pesaran and Shin (1996) studied the procedure of ARDL models for the estimation of long-term connections with variables integrated at I (0) order. The analysis becomes a little complex when the variables are at different-stationary or integrated of order 1 (I (1)). The cointegration procedure for this study is more about the examination of the long-run relationship between I (1) variables. Subsequently, a greater number of different estimates and hypotheses testing is dependent on this and precisely it is adopted for the investigation of I (1) variables (Pesaran & Shin, 1996). Considering the study of Pesaran and Shin (1996), the ARDL (p,q) model will be used as the main equation:

$$Y_t = \text{con} + \alpha_1 + Y_{t-1} + \beta_1 X_t + \beta_2 X_{t-1} + \beta_3 \pi + \beta_4 \pi_{t-1} + \varepsilon_t \quad (2)$$

Where  $Y_t = \Delta Y_t + Y_{t-1}$ ,  $X_t = \Delta X_t + X_{t-1}$ ,  $\pi_t = \Delta \pi_t + \pi_{t-1}$  and  $\varepsilon_t$  is error term,  $X_{t-1}$ ,  $X$  are the short run and the long-run coefficients of the model, respectively, and  $\Delta$  is the 1st difference operator.  $T(t)$  denotes time, the lag selection criterion is based on the

AIC (Akaike Information Criterion) with X and Y as the vectors for the cointegration test. The long run and the short-run coefficient are estimated with much emphasis placed on the length, which talks about the main objective of the study, foreign investment and growth in emerging economies.

### Findings

The variables for study are estimated for unit roots in level intercept and 1st Difference intercept as well. The lag selection criterion is according to the Schwarz information criterion SIC. Table 2 indicates the results unit root results. The findings from the test show that GDPPC, OPEN, INFLATION, and labor are stationary at a level signifying that these variables are I (0) with the exception of foreign direct investment. In addition, after estimating the test at 1st difference all the variables both the dependent and independent variables became non-stationary meaning the null hypothesis of unit root is rejected after the 1st Difference estimation thus the variables are corrected at the order (1).

**Table 2. Panel Unit Root Results**

UNIT ROOT VARIABLES	LEVEL INTERCEPT		1ST DIFFERENCE INTERCEPT	
	T. STATISTICS	PROB	T. STATISTICS	PROB
GDPPC	2.31096	0.9896	-3.41859	0.0003***
OPEN	2.28593	0.9889	-3.41375	0.0003***
FDI	-2.03737	0.0208**	-9.90427	0.0000***
INF	5.01894	1.0000	-0.61306	0.2699
LAB	6.10720	1.0000	-5.18347	0.0000***

Note: 1. Levin, Lin & Chu t\*. (\*\*\*) , (\*\* ) and (\*) indicate statistical significance at 1%, 5% and 10% respectively.

Source: own study.

Table 3 gives the overall reports on the estimation results from equation 1 indicating the contribution of foreign direct investment on economic growth in Africa. GDPPC was used as a dependent variable in the equation with trade openness, foreign direct investment, inflation, and total labor force as the explanatory variables. Panel ARDL method was used to determine the long and short-run impact of the explanatory variables on the dependent variables, the selected ARDL model for this investigation is ARDL (1, 1, 1, 1, 1), with Akaike info criterion used as a lag selection criterion. The model estimated to come out with a Log-likelihood of 137.7832 and a standard deviation as 0.126701.

In the long-run estimation, all the explanatory variables have a positive impact and contribution to the dependent variable. It is noted that there is a strong relationship between trade openness and economic growth with a coefficient of 1.097811 and a probability of 0.0000 indicating that trade openness is significant at a significant level of 1%. (Appiah, Frowne, & Frowne, 2019) evidence this in a study. Barro and Sala-i-Martin (1995) also confirmed that there is a positive relationship between trade openness and economic in his book. Again, it asserted the positive significant effects of trade openness on economic growth. Trade Openness stimulates the allocation of resources efficiently through relative advantage, allows the transfer of knowledge and technical progress, and promotes competitions in both international and domestic markets (Chang, Kaltani, & Loayza, 2009). The results did not agree with a study by Durham (2004) who researched and failed to confirm a positive relationship between trade openness and growth.

**Table 3. ARDL Results (Selected Model: ARDL (1, 1, 1, 1, 1))**

LONG RUN RESULTS				
Variable	Coefficient	Std. Error	t-Statistic	Prob.*
LOG (OPEN)	1.097811	0.104336	10.52190	0.0000***
LOG (FDI)	0.101374	0.030687	-3.303538	0.0015***
LOG (INF)	0.367305	0.106134	3.460773	0.0009***
LOG (LAB)	-1.927860	0.344986	-5.588234	0.0000***
SHORT RUN RESULTS				
DLOG (OPEN)	0.159927	0.120286	1.329562	0.1879
DLOG (FDI)	0.030842	0.028587	1.078887	0.2843
DLOG (INF)	-0.005499	0.002444	-2.249686	0.0276**
DLOG (LAB)	-0.059486	0.560378	-0.106154	0.9158
C	3.888296	0.911158	4.267422	0.0001
MODEL FITNESS RESULTS				
Mean dependent var 0.055289	S.D. dependent var 0.126701			
S.E. of regression 0.087778	Akaike info criterion -1.976823			
Sum squared resid 0.547052	Schwarz criterion -1.117445			
Log-likelihood 137.7832	Hannan-Quinn criteria. -1.628586			

Note: (\*\*\*) , (\*\*) and (\*) indicate statistical significance at 1%, 5% and 10% respectively.

Source: own study.

From the results stated above, it's seen that in the long run there is a significant contribution of foreign direct investment on economic growth. Based on the prob value of 0.0015 stating it is significant at a level of 1%, meaning when more and more of technology transfer and the use of modern equipment and machinery are employed in developing countries it results in increase in economic growth in Africa. This is proved by a study conducted by Borensztein *et al.* (1998) stating the positive significant contribution of foreign direct investment on economic growth. Again, Su and Liu (2016) proved that there is indeed a positive sign of foreign growth. Again, Su and Liu (2016) proved that there is indeed a positive sign of foreign direct investment on economic growth in their study. Evidenced by Sunde (2017) in his study showed that there is a direct relationship between economic growth and foreign direct investment.

In Africa, a major determinant of macroeconomics has been inflation, since the rate of inflation is very high in most African countries. The results stated that, in the long-run inflation affects economic growth. It can be explained that a percentage increase will result in increase in economic growth. This means that inflation is a serious determinant of economic growth in Africa; cost of production is relatively high when there is high rate of inflation leading to low economic growth but a minimal or lower rate of inflation will intend increase economic growth as recorded in the results above. Barro and Sala-i-Martin (1995) who researched on inflation and economic growth, Jones and Manuelli (1995) evidenced this result to prove that inflation affects economic growth positively at the time he investigated about growth and the effects of inflation.

Labor force plays a very vital role in the economic growth of most African countries. In the results above, there is a positive sign of labor on economic growth, it is evidenced that labor is significant at a significant level of 1% stating that there was a significant effect of labor on economic growth in Africa from 1995 to 2015. This is proved by a study

conducted by Khan (2007) who proved that the employment elasticity of GDP growth in emerging countries to be positive at the worldwide level, again Ajilore and Yinusa (2011) studied that total employment has grown between 0.3 and 0.38 for every 1% additional increase of GDP growth.

In the same vein, it can be noted in the above results that, none of the explanatory variables with the exception of inflation is a short-term measure and determinant for economic growth. All the variables are insignificant at all levels being it 10%, 5%, and 1%. For a quick measure of economic growth, inflation is a very important factor in the short run, thus the rate of inflation should be decreased to reduce the cost of production of goods and services.

## CONCLUSIONS

The contributory role of foreign investment in growth in Africa in recent years has received much consideration by researchers and policymakers. Studies on this area available are not clear. In most recent studies, foreign direct investment has emerged as a determining factor of economic growth. In light of this fact, the current study is an attempt to investigate the contributions of foreign investment on economic growth in developing economies of Africa. This study uses yearly panel data for the period 1995-2015 for 5 developing economies of Africa. The results of Panel ARDL (PMG) indicate that foreign investment has a positive impact on economic growth as well as a positive sign of trade openness, inflation, and labor. The study stresses that for increasing economic growth there is a need to seek more foreign investments, increase trade openness and inflation at the same time improve upon employment conditions in selected African developing countries.

Foreign investment helps in the growth and development of the economy. It is therefore recommended that as far as a foreign investment only does not improve the economy it also help to improve the standard of living for individuals of host countries. It is therefore appropriate for governments and administrations to set up policies to induce foreign investment inflow. Governments and administrations can introduce tax-free holidays for investors etc.

Again, improve human life can be a good source of growth of the economy as to governments providing social amenities like good roads, the provision of good and quality health care to individuals. The introduction of policies like health insurance, subsidization of tuition fees will help in the improvement and development of the human capital.

Most African countries are faced with the issue of inflation, governments and administrations can put up strategies to reduce the rate of inflation. Governments can encourage the patronage of locally produced goods and services to reduce the importations, which in turn will help reduce the rate of inflation.

There are some limiting factors hindering the study. This study only dealt with a few African countries and not all emerging countries on the African Continent. Again, there was a problem with data availability and that led to the limitation of data from 1995-2015. The selection of factors and variables differ from other research studies and became a limitation since there was no data available for such variables. Lack of funds for the purchase of data other than what is available from international organizations was another limiting factor. Finally, some recommendations are not applicable to some developing African countries because of different economic situations and climatic conditions.

We encourage further work in this range to better the findings. The data as it expanded back to 2015, anticipating utilize long time-series data. Maybe the study countries

do not talk for the complete squib Saharan Africa region. At last, we consider the potential for foreign investment to have countrywide impacts, but macro provision may emerge at regional (i.e. Provincial levels) indeed, in the event that they are not countrywide. These limitations warrant proceeding study of this issue.

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# Entrepreneurship development in Japan: An empirical analysis

Tareq Lubbadah

## ABSTRACT

**Objective:** The purpose of this article is to evaluate the entrepreneurship development of Japan and comparing its performance against leading countries in the same region, mainly Hong Kong, and Taiwan.

**Research Design & Methods:** We implement the Global Entrepreneurship Index GEI methodology, where the GEI methodology focuses on quality-related institutional and individual aspects of entrepreneurship. Moreover, we utilised a novel feature of the GEI the Penalty for Bottleneck PFB methodology to produce induction of which entrepreneurial elements should be addressed and how much effort needs it to lighten Japan bottleneck.

**Findings:** Japan's entrepreneurial performance is relatively modest compared to some countries in the same region, especially in individual variables. Japan's entrepreneurial profile strengths are in the institutional features (e.g., country risk), while the instability in the profile back to individual variables (e.g., population perception and motivation). The country has three fundamental bottlenecks in its performance opportunity perception, start-up skills, and networking pillars. The GEI data used in the study only covers the 2006-2016 period. Japan should be focused on the three bottlenecks opportunity perception, start-up skills, and networking to improve its entrepreneurial performance by developing an education policy that focuses on entrepreneurship.

**Contribution & Value Added:** This paper identifies the vulnerable aspects of Japan's performance by using a novel methodology that combines individual and institutional variables in a single model. Also, the use of (PFB) to detect which entrepreneurial components should be addressed.

**Article type:** research article

**Keywords:** Japan; Entrepreneurship; GEI; GEM; Penalty for Bottleneck

**JEL codes:** L26, O1, F01

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## INTRODUCTION

Entrepreneurship is influenced by the country in which it operates, as well as in the region where it is situated. Japan is a world apart culture with its original civilisation and history. The country, is positioned in East Asia not very far from Korea or China, has an innovation-driven economy (Tilak, 2002). Also viewed as one of the most advanced economies in Asia and the world, the country spending on R&D in 2017, exceeds 3% of GDP surpasses the total OECD countries (OECD, 2019b). In 2018 the GDP per capita amounted to 4.971 trillion US dollars, with a GDP growth rate 0.78% and purchasing power parity (PPP) of 5.415 trillion dollars in 2018 (OECD, 2019a; World Bank, 2019a). Since the early 1990s, the Japanese government has promoted entrepreneurship policy as an integral part of economic development policy (Aoyama, 2009). Also, the current prime minister, Shinzō Abe, is committed to support the entrepreneurship activity as his government placed a goal of doubling the business entry rate and TEA rate in 2020 (Kegel, 2016).

Although this development in the economy and the government interest in promoting entrepreneurship, still the entrepreneurship levels in Japan are inferior to other countries like Taiwan and Korea. According to the GEM data, the level of entrepreneurial activity in Japan was disproportionately low for Innovation-driven economies. Where the rate (TEA) throughout the last 18 years did not exceed 5.4% (Global Entrepreneurship Monitor [GEM], 2018). There are different explanations for the low ratio, such as community ageing, Japan culture, education orientation, and the population attitudes toward entrepreneurship (Martin, 2019; Shinato, Kamei, & Dana, 2013). Most of the studies that examined entrepreneurship were based on individual or institutional data (Honjo, 2015), but the current study relies on the GEI methodology, which combines both individual and institutional variables in a single model.

This paper utilises an innovative methodology; the Global Entrepreneurship Index (GEI), to examine and evaluate the overall entrepreneurship performance of the country and to measure the country's entrepreneurship level (ecosystem). This approach is unique as it blends quality-related institutional and individual factors, which allows measuring the performance on the individual and institutional levels in a single model, while the GEM survey designed to collect individual data about the population (Szerb & Trumbull, 2018). Also, we used this approach to compare the country's profile to leading countries in the same region. The results show that the country profile is modest compared to Hongkong and Taiwan. Moreover, through this methodology, we were able to distinguish and identify the strengths and the weakness of the country performance. The results reveal that Japan has significant hold-up in individual entrepreneurship features. Finally, we used a unique feature of the GEI, the bottleneck methodology PFB to simulate a situation where a country can improve its performance by allocating more entrepreneurship resources to the weakest links in the model. The simulation implies that Japan should focus its resources on opportunity perception, start-up skills, and networking pillars to improve its performance. Thus we were able to provide a thorough and multilevel view about the country entrepreneurial performance. Added to that, producing policy recommendations that can help in intensifying its entrepreneurship performance by targeting the most vulnerable link in the system.

The paper is formed as follows. First, it presents the literature, followed by an examination of the country entrepreneurship profile based on some of the Global

Entrepreneurship Monitor (GEM) measures and indicators. After that, it discusses the (GEI) methodology. In the fifth part, the paper investigates Japan's performance-based on the GEI. Next, it compares the country performance to Hong Kong and Taiwan. Following, it uses the bottleneck methodology PFB to identify the most vulnerable links in the system to seize the system performance and simulate a scenario where Japan can increase its GEI score by allocating more entrepreneurship resources. The conclusion in the last part.

## LITERATURE REVIEW

Japan is known for having entrepreneurship hindrance (Honjo, 2015; Nakayama, 2016; Shinato *et al.*, 2013). A vast number of studies investigated the entrepreneurship situation in Japan. The shortage of entrepreneurship in the country manifests itself in different tangible pieces. According to the GEM : 2001 Executive Report, the culture in Japan is unfavourable for entrepreneurs, and the entrepreneurs themselves do not possess the necessary facilities to start and operate a business (Reynolds, Camp, Bygrave, Autio, & Hay, 2002). Shinato *et al.* (2013), pointed out that the traditional cultural climate hindered the development of entrepreneurship in the country, and the entrepreneurship education is limited to MBA or MOT courses (Shinato *et al.*, 2013). Honjo (2015), examined the individual factors that influence entrepreneurial activities in Japan using the GEM data. Honjo found that entrepreneurial activities and attitudes in the country are low. He also noticed that Japanese people who are perceived to have the needed skills and knowledge to start up a business are more apt to start a business compared to other countries (Honjo, 2015).

Nakayama (2016), studied the factors that contribute to the entrepreneurial intention of university students in Japan. Nakayama found that entrepreneurial self-efficacy, having a specific business idea, and entrepreneurial education has a significant part of the student intention. Nevertheless, he also suggested that the fear of failure contributes largely to diverting the interest of some students away from entrepreneurship (Nakayama, 2016).

Kegel (2016), conducted a multilevel comparison on the startup entrepreneurial activity between the United States and Japan. The study found that the United States presents a dynamic environment to support entrepreneurial activity in several entrepreneurial activity factors such as culture, education, and entry regulation. However, Japan showed instability in entrepreneurial education, entry regulation, culture, but it showed positive signs in physical infrastructure, government policy, and R & D transfer. Kegel also argued on the value of immigration to entrepreneurial activity (Kegel, 2016). According to the above, we can note that the entrepreneurship in Japan, features lack in entrepreneurship education, also unfavourable culture and attitude toward entrepreneurship.

## JAPAN ENTREPRENEURIAL PROFILE BASED ON GEM

The Global Entrepreneurship Monitor (GEM) is an international research program that monitors and examines the relationship between entrepreneurship and the development in the economy by measuring entrepreneurial activities across countries (Marvel, 2012). The GEM was launched in 1998 and provided corresponded data on people's attitudes, perceptions, and motivation toward entrepreneurship, and entrepreneurial activity, that can be employed to examine the entrepreneurship development in

a single state, and cross-sectional states (Reynolds *et al.*, 2005; Singer, Herrington, & Menipaz, 2018; Sternberg & Wennekers, 2005).

The principal objective of the GEM program has been to examine “differences in national levels and types of entrepreneurship and to link these to job creation and economic growth” (Singer *et al.*, 2018, p. 33).

In this section of the article, we portray Japan’s entrepreneurial performance through some of GEM entrepreneurship individual measures.

Perceived capabilities, this percentage totalled only 10% in 2018 (Bosma & Kelley, 2018). Which reflects that only 10% of the adult population believes that they hold the required abilities and experience to start a business, this ratio is inferior to the regional and global averages, 49.15% and 49.19% respectively. This indicates that there is a lack of exposure to entrepreneurialism in the early stages of education. Fear of failure, this indicator shows that anxiety of failure would hinder the adult population from initiating up a business. As Japan seized 46.4% in 2018; this ratio is high compared to the regional and global averages of 38.1% and 36.2% sequentially (Bosma & Kelley, 2018, p. 88). Perceived Opportunities, presents the proportion of the adult population (18-64), who sees an excellent opportunity to start a firm (Singer *et al.*, 2018). This ratio stood at 8.1%; in 2018 (Bosma & Kelley, 2018, p. 88).

Total early-stage entrepreneurial activity (TEA), the TEA indicator describes the portion of the adult population who either a nascent entrepreneur or running a business (Singer *et al.*, 2018; Szerb & Trumbull, 2018). The TEA ratio for Japan reached only 5.3% in 2018, while the regional average in the same year was, 12.65% (Bosma & Kelley, 2018, p. 88), this can be attributed to several reasons previously stated. The TEA rate in Japan is disappointingly low, but this measure reflects only the percentage of the population involved in entrepreneurship activities (necessity entrepreneurs), not the quality of entrepreneurship activities (Ács, Szerb, & Lloyd, 2017). Established Business Ownership (EB), only 6.2% of Japan’s population are currently owner-manager of an established business in 2018, where the regional and the global average 9.34% and 8.50%, respectively (Bosma & Kelley, 2018, p. 88). Employee entrepreneurial activity (EEA), in 2018, was only 2.17% of the adult population involved in entrepreneurial activities (Bosma & Kelley, 2018).

The self-employment rate indicates the ratio of workers who work for themselves. This percentage in Japan only accounted for 10.2% in 2018 (World Bank, 2019c); this corresponds with the TEA measure; as we mentioned shortly, the TEA ratio is moderate in Japan matched to the neighbouring countries. So it is reasonable to have a low self-employment rate, where the number of people engaged in entrepreneurship activities is small, and where the majority of the population turned to the dominant companies to work in.

According to the above individual measures and indicators, we can note that Japan’s performance is infernal in comparison with the regional and global average. However, the self-employment rate and TAE only measures the quantitative aspects of entrepreneurship. According to Ács *et al.* (2017), countries require fewer self-employment rates and more qualitative aspects. They found that TEA correlates negatively with development measures, specifically, the index of economic Freedom (−0.27), global competitiveness index (−0.46), and ease of doing business index (−0.57) (Ács *et al.*, 2017, pp. 31).

## MATERIAL AND METHODS

The Global Entrepreneurship Index GEI was developed by Ács, Autio and Szerb (Ács, Autio, & Szerb, 2014; Ács, Rappai, & Szerb, 2011; Ács & Szerb, 2009) to capture country-level entrepreneurship (Szerb, Komlósi, & Páger, 2016). Ács *et al.* (2014) define the entrepreneurial ecosystems as “dynamic institutionally embedded interaction between entrepreneurial attitudes, abilities, and aspirations, by individuals, which drives the allocation of resources through the creation and operation of new ventures” (Ács *et al.*, 2014, p. 11). As every ecosystem consists of different pillars, the GEI consists of 14 pillars, formed by individuals and institutions variables, which interacts with each other to create an entrepreneurship ecosystem, which the entrepreneurial activity is the output of the ecosystem (Ács *et al.*, 2017).

The GEI is a composite indicator of the health of the entrepreneurship ecosystem in a given country (Ács, Szerb, Lafuente, & Lloyd, 2018). It is a multilevel structure consists of three sub-indexes (Attitudes, Abilities, and Aspirations) (3As), which comprises 14 “pillars”<sup>1</sup> that merge both individual-level and country-level institutional variables (Szerb *et al.*, 2016; Szerb & Trumbull, 2018).

The GEI methodology focuses on the quality aspects of entrepreneurship instead of quantity. The GEM measures the quantity aspects of entrepreneurship. For example, as previously seen, Japan’s self-employment rate is low, and this does not reflect the economic development as the Japanese economy is the third-largest in the world regarding GDP. The methodology focuses on the quality aspects of entrepreneurship not on the number of small enterprises (vending machine) but on the quality of innovative enterprises that adds value to society (Ács *et al.*, 2017).

The GEI takes into account both individuals and institutions aspects of entrepreneurship, while the GEM focuses on collecting individual measures of the population. The GEI adds macro-level institutional dimensions such as (culture, education, and market size) (Szerb *et al.*, 2016; Szerb & Trumbull, 2018), hence the GEI is a valuable tool to help countries accurately assess and evaluate their ecosystem to add value to society.

The GEI is a compound index consists of a four-level index (Ács *et al.*, 2017, p. 93):

- variables,
- pillars,
- sub-indices,
- super-index.

Each of the three sub-indices<sup>2</sup> contains individual and institutional variables. The Entrepreneurial attitudes sub-index: reflects the individual’s orientation towards entrepreneurship. The Entrepreneurial abilities sub-index: reflect the entrepreneurs’ characteristics to turn the opportunity into action. Finally, Entrepreneurial aspiration sub-index: reflect the entrepreneur’s efforts to start a new venture. (Ács *et al.*, 2014, 2017).

A novel feature of the GEI method is employing the Penalty for Bottleneck PFB methodology; the GEI can distinguish the weakest link (lowest value) in the system to capture the system performance. The worst performing pillars serve as a bottleneck that holds

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<sup>1</sup> For detailed description about the methodology of the pillars, see (Ács *et al.*, 2014).

<sup>2</sup> For more detail about the constructing of sub-indexes ATT, ABT, and ASB see (Ács & Szerb, 2009).



back the ecosystem performance. Therefore, the best performing pillars are “penalised” because of the distortion. The extent of the penalty depends on the differences between the bottleneck pillar and a particular pillar, the higher the magnitude of the bottleneck, the greater is the penalty (Ács *et al.*, 2014; Szerb *et al.*, 2016).

The PFB draws policy attention to infirmities aspects of the entrepreneurial ecosystem through which appropriate policies can be developed to address it (Ács *et al.*, 2017; Szerb & Trumbull, 2018). These features make the GEI a proper approach to analyse the entrepreneurial ecosystems.

### JAPAN’S ENTREPRENEURIAL PERFORMANCE BASED ON GEI

In this section of the article, we will analyse Japan’s entrepreneurial performance by relying on the GEI. The analysis will focus on the 2012-2016 GEI data for Japan.

Table 1 displays the rank of the countries’ overall GEI scores for the 2012-2016 averages; we have data for 95 countries in this period. Also, the table shows the Global Competitiveness Index classification, where 1 indicates resource-driven countries (least developed nations), 2 indicates efficiency-driven countries (increasingly competitive), and 3 indicates Innovation-driven economies (most developed nations) (Szerb & Trumbull, 2018).

**Table 1. Japan position in in global entrepreneurship index rank 2012-2016 average**

Rank	Country	GDP per capita	GEI	Stage	Rank	Country	GDP per capita	GEI	Stage
1	United States	51,88	82.5	3	49	Uruguay	19,491	34.1	2
2	Switzerland	56,39	78.9	3	50	Barbados	15,35	34	2
3	Canada	42,83	78.3	3	51	South Africa	12,38	33.4	2
4	Australia	43,88	74.9	3	52	Croatia	20,52	32.3	2
5	Sweden	44,57	74.7	3	53	Costa Rica	14,13	31.5	2
6	Denmark	44,70	73.7	3	54	Lebanon	13,03	31	2
7	United Kingdom	37,84	72.2	3	55	Kazakhstan	23,50	30	1
8	Ireland	52,55	70.3	3	56	Belize	7,941	29.8	2
9	Netherlands	45,95	69.2	3	57	Namibia	9,113	29.4	2
10	Finland	39,35	68.1	3	58	Macedonia	12,31	29.1	2
11	Hong Kong	54,27	67.3	3	59	Morocco	7,276	28.2	2
12	France	37,57	65.2	3	60	Thailand	15,000	27.7	2
13	Austria	44,21	65.2	3	61	Peru	11,55	27.4	2
14	Germany	43,40	64.2	3	62	Mexico	16,52	26.6	2
15	Belgium	41,21	63.3	3	63	Bulgaria	17,35	26.5	2
16	Taiwan	37,83	63	3	64	Panama	19,82	26.4	2
17	Israel	31,67	61.1	3	65	India	5,578	26.3	1
18	Chile	22,16	59	2	66	Georgia	9,008	25.3	2
19	Luxembourg	94,27	58.5	3	67	Trinidad & Tobago	31,59	25.3	2
20	Norway	63,17	58.2	3	68	Russia	24,732	24.7	2
21	Estonia	26,772	56	3	69	Egypt	10,079	24.2	2
22	Qatar	119,53	55.4	3	70	Philippines	6,589	23.9	1
23	Korea	33,372	53.6	3	71	Argentina	19,017	23.8	2
24	Slovenia	28,592	52.9	3	72	Iran	16,184	22.5	2
25	Singapore	78,294	52.1	3	73	Ghana	3,720	22.5	1
26	Japan	36,946	49.4	3	74	Algeria	13,207	22.2	1

Rank	Country	GDP per capita	GEI	Stage	Rank	Country	GDP per capita	GEI	Stage
27	Cyprus	31,196	48	3	75	Vietnam	5,386	22.2	1
28	Portugal	26,208	47	3	76	Nigeria	5,409	22	1
29	Poland	24,484	46.9	2	77	Jamaica	8,090	21.7	2
30	Lithuania	25,150	46.4	2	78	Bolivia	6,325	21.4	1
31	Spain	31,691	45.6	3	79	Indonesia	10,195	21.1	2
32	Turkey	21,871	45	2	80	El Salvador	7,743	20.7	2
33	Puerto Rico	33,844	44.6	3	81	Bosnia and Herzegovina	10,224	20.7	2
34	United Arab Emirates	67,133	44.6	3	82	Ecuador	10,630	20.5	2
35	Slovakia	27,489	42.8	3	83	Brazil	14,922	20.4	2
36	Latvia	22,298	42.3	2	84	Zambia	3,543	20.3	1
37	Czech Republic	28,380	40.4	3	85	Senegal	2,297	19.7	1
38	Saudi Arabia	50,458	40.2	2	86	Guatemala	7,203	18.4	2
39	Hungary	23,946	39.4	2	87	Suriname	15,371	17.9	2
40	Tunisia	10,577	38.8	2	88	Pakistan	4,367	17.5	1
41	Colombia	12,592	38.3	2	89	Libya		17.2	1
42	Italy	34,452	38.1	3	90	Malawi	1,051	16.6	1
43	Jordan	8,390	36.5	2	91	Ethiopia	1,231	15.5	1
44	China	12,765	35.9	2	92	Cameroon	740	15.3	1
45	Greece	24,092	35.9	3	93	Uganda	1,646	13.9	1
46	Malaysia	24,132	35.5	2	94	Angola	6,148	13.8	1
47	Romania	19,376	35.0	2	95	Burkina Faso	1,560	12.5	1
48	Botswana	15,271	34.3	1					

Note: GDP per capita in international \$ World Bank.

Source: own elaboration based on (Szerb & Trumbull, 2018).

The highlighted countries with light grey are all located in East Asia. We can notice that Japan is an innovation-driven economy and occupies 26th place in the global rankings, with a (49.4) GEI score, behind Hong Kong, Taiwan, and Korea.

Japan's overall performance at the 26th in the world and the fourth in East Asia is a little surprise for an innovation-driven country.

Table 2 presents more details about Japan's entrepreneurial performance at sub-indexes and pillars level.

Table 2 illustrates the three sub-indices (Attitudes, Abilities, and Aspiration) components, the 14 pillars, and their scores.

The pillars shaded in dark grey scored the lowest results (lousy performance); the shaded in light grey have an average score, while the pillars in white achieved the highest results.

The attitude sub-index pillars, opportunity perception, start-up skills, and networking are critically low bottleneck pillars. At the same time, Japan scores high in risk acceptance; which combines the population risk perception (fear of fail) with the country's business risk (Ács *et al.*, 2017).

In the ability sub-index, Japan scores high in all the pillars except competition, indicating that an influential business group governs the market or/and vice in competition regulation. Only one component in aspiration sub-index scored low, risk capital; which can reflect inadequate financial resources (Ács & Szerb, 2009; Shinato *et al.*, 2013).

**Table 2. Japans entrepreneurial profile at sub-indexes and pillars level 2012-2016**

Sub-indexes	PILLARS	Score
<b>Entrepreneurial Attitudes (ATT)</b>	Opportunity Perception	0.17
	Start-up skills	0.12
	Risk Acceptance	0.64
	Networking	0.30
	Cultural Support	0.37
	<b>ATT</b>	<b>28.9</b>
<b>Entrepreneurial Abilities (ABT)</b>	Opportunity Startup	0.61
	Technology Absorption	0.95
	Human Capital	0.93
	Competition	0.52
	<b>ABT</b>	<b>57.9</b>
<b>Entrepreneurial Aspirations (ASB)</b>	Product Innovation	0.90
	Process Innovation	1.00
	High Growth	0.98
	Internationalization	0.66
	Risk Capital	0.57
	<b>ASB</b>	<b>61.5</b>
	<b>GEI</b>	<b>49.4</b>

Note: Pillars and sub-indexes are normalised values.

Source: own elaboration based on GEI data 2012-2016 averages.

Table 3 presents a further thorough analysis of Japan's entrepreneurial profile at the institutional and individual levels.

Almost all of Japan's institutional variables are among the best countries (top 25%) except three institutional variables shaded in light grey are among the top 50%; this is expected from the well-developed and innovative country and well-equipped to support entrepreneurial activity.

Japan is among the worst countries in six individual variables (worst 25%) shaded in darkest grey and just in one variable below the average shaded in dark grey.

Five of the individual variables shaded in the greyest zone, are all in the ATT sub-index. This means that the entrepreneur's traits and attitudes toward entrepreneurial activities are shallow compared to other countries, which are consistent with Honjo (2015), and Nakayama (2016). This can be associated with various reasons. Such as reduced exposure to entrepreneurship, especially at a young age, and overlooking the entrepreneurial culture in schools, as well as to particular causes related to the Japanese culture such as low tolerance of failure, which has a profound impact on the social relationship (Ács *et al.*, 2017; Shinato *et al.*, 2013).

In the attitudes sub-index, only one individual variable has deficient scores (competitors), indicating the Japanese market characterised by high barrier entry that restricts start-up businesses from entering and compete with other companies or similar non-innovative products in the market consist with Kegel (2016). The highest-scoring sub-index is entrepreneurial aspirations attributed to the entire individual and institutional variables except for the export variable.

**Table 3. Japan’s entrepreneurial profile at the variable level based on 2012-2016 averages**

PILLARS		INSTITUTIONAL VARIABLES		INDIVIDUAL VARIABLES	
Opportunity Perception	0.17	Freedom	0.82	Opportunity Recognition	0.11
Start-up skills	0.12	Education	0.72	Skill Perception	0.10
Risk Acceptance	0.64	Country Risk	1.00	Risk Perception	0.40
Networking	0.30	Connectivity	1.00	Know Entrepreneurs	0.21
Cultural Support	0.37	Corruption	0.84	Career Status	0.18
<b>ATT</b>	<b>28.9</b>	–	–	–	–
Opportunity Startup	0.61	Governance	0.75	Opportunity Motivation	0.62
Technology Absorption	0.95	Technology Absorption	0.99	Technology Level	0.92
Human Capital	0.93	Labor Market	0.92	Educational Level	0.86
Competition	0.52	Competitiveness and Regulation	0.96	Competitors	0.30
<b>ABT</b>	<b>57.9</b>	–	–	–	–
Product Innovation	0.90	Technology Transfer	0.99	New Product	0.68
Process Innovation	1.00	Science	1.00	New Technology	0.58
High Growth	0.98	Finance and strategy	0.77	Gazelle	0.96
Internationalization	0.66	Economic complexity	1.00	Export	0.61
Risk Capital	0.57	Depth of Capital Market	0.97	Informal Investment	0.62
<b>ASB</b>	<b>61.5</b>	–	–	–	–
<b>GEI</b>	<b>49.4</b>	<b>Institutional</b>	<b>0.91</b>	<b>Individual</b>	<b>0.51</b>

Note: white: best 25%; light grey: best 50%; dark grey: worst 50%; most shaded grey: worst 25%.

Source: own elaboration based on GEI data 2012-2016 averages

The focus should be on the individual –variables where the average of individual variables was 51 shaded in darkest grey (worst 25%), which signifies a problem in Japan’s entrepreneurial performance.

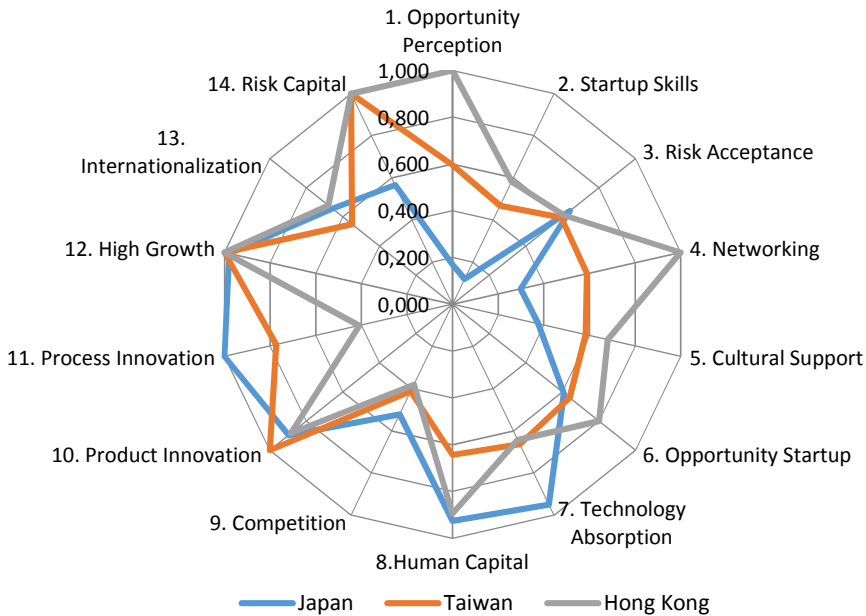
**COMPARING JAPAN’S ENTREPRENEURIAL PERFORMANCE TO HONG KONG AND TAIWAN**

In this section, we evaluate Japan’s performance compared to Hong Kong and Taiwan at the level of the entrepreneurship pillars in figure 1.

The selection of Taiwan and Hong Kong for the comparison with Japan is due to several reasons first the geographical location of the three countries located in East Asia, the convergence of GDP per capita, Taiwan (37831.6), and Japan (36946.3), except Hong Kong (54279), the similarity of the culture of the three countries. Plus, the three countries are considered as Innovation-driven countries based on the Global Competitiveness Index Classification. Despite this similarity, Hong Kong ranked 16th with 67.3 GEI average score, and Taiwan ranked 11th with an average of 63, ahead of Japan in the 26 places.

We can discern that Hong Kong is the top performance in Asia and globally in many pillars, such as opportunity perception, networking, and Risk Capital (perfect score pillars). Nevertheless, Hong Kong faces a significant bottleneck, first in competition pillar, which could be due to weak competition law and regulation or because of the presence of dominant companies in the markets. Second, the process innovation pillar, which reflects the adoption of new technology by start-ups and “GERD”; the amount of domestic expenditure on R&D. The reason for this decline is low spending on research and development, as the country expenditure on R&D was only 0.8% of GDP in 2017 (World Bank, 2019b), as

well as Hong Kong government, is less open to innovation and adopting new technologies. Hong Kong excels Japan significantly, almost in all attitudes related pillars, except risk acceptance. Japan should follow the lead of Hong Kong in the mentioned aspects.



**Figure 1. Pillar level compression of Japan, Taiwan, and Hong Kong**

Source: own elaboration based on GEI data 2012-2016 averages.

Taiwan also considered as a top performer after Hong Kong, especially in product Innovation and risk capital. Taiwan has the competition pillar as a bottleneck like Hong Kong and Japan, which indicates that a few companies have monopolistic power in the market. Besides, the start-up skills as a bottleneck resembling Japan; this can be addressed by education policy. On the other hand, Japan surpasses both Hong Kong and Taiwan in technology absorption and process innovation pillars.

### IMPROVING ENTREPRENEURSHIP IN JAPAN: A SIMULATION

In the prior section, we investigated Japan's entrepreneurial performance and matched it with Hong Kong and Taiwan's performance based on the GEI index; also, we identified the depths and gaps in Japan's performance. In this part, we will try to provide policy suggestions to help Japan in improving the entrepreneurship performance by using the PFB<sup>3</sup> methodology, by simulating a scenario in which Japan allocate more entrepreneurship resource to gain a 10 point increase in the GEI index average, from 49.4 to 59.4.

The PFB approach assumes that entrepreneurship performance depends on the weakest pillars (poor performance). By increasing the bottleneck pillar, the whole GEI score can

<sup>3</sup> For more details about the PFB methodology and GEI method see (Ács *et al.*, 2017, pp. 86–112)

be improved (Ács, Rappai, & Szerb, 2011; Szerb *et al.*, 2016). In other words, what is the “optimal” allocation of entrepreneurship policy resources to achieve an increase in the GEI? and how should the added support be allocated? (Szerb *et al.*, 2016, p. 18).

Table 4 shows Japan’s bottleneck pillar and the necessary improvement in the pillars after a 10 point increase in the GEI average.

**Table 4. Simulation of maximising Japan GEI index average by 10 points**

Sub-indexes new score	PILLARS		Required Increase in Pillar	Percentage of the total new effort
<b>Entrepreneurial Attitudes</b>	Opportunity Perception		0.18	39%
	Start-up skills		0.23	50%
	Risk Acceptance		0.0	0%
	Networking		0.05	11%
	Cultural Support		0.0	0%
	<b>ATT</b>	<b>40.3</b>		
<b>Entrepreneurial Abilities</b>	Opportunity start-up		0.0	0%
	Technology Absorption		0.0	0%
	Human Capital		0.0	0%
	Competition		0.0	0%
			<b>ABT</b>	<b>66.5</b>
<b>Entrepreneurial Aspirations</b>	Product Innovation		0.0	0%
	Process Innovation		0.0	0%
	High Growth		0.0	0%
	Internationalisation		0.0	0%
	Risk Capital		0.0	0%
			<b>ASB</b>	<b>71.1</b>
	<b>GEI</b>	<b>49.3</b>		

Source: own calculations based on GEI index data 2012-2016 averages.

According to the table, the most prominent bottleneck pillars are start-up skills, opportunity perception, and networking all in the attitudes sub-index, which is consistent with Honjo (2015) and Martin (2019).

We can see that to improve Japan GEI average index by 10 points, this will call for using 50% of the total effort in the start-up skills for 0.23 required increase in the pillar, a 39% improvement in opportunity perception for an 0.18 required increase in the pillar, and the rest of the total effort needed in Networking for 0.05 required increase in the pillar.

If Japan wants to improve its entrepreneurial performance, the focus should be toward those areas. The start-up skills pillar consist of skill perception and education. This can be addressed through promoting education policy, such as adding a training curriculum to improve students’ entrepreneurial skills needed to start or advance a business. Also, employing more entrepreneurs as lecturers, especially those with expertise in creating a start-up, to provide more realistic and valuable guidance (Shinato *et al.*, 2013).

Opportunity Perception pillar consists of two variables opportunity recognition and freedom (Ács *et al.*, 2017). The freedom variable got a high score of 82% comprised of two variables “economic freedom and property rights”. Still, the drawback is in opportunity recognition, which is only 11%, and this could also be approached by education policies,

more exposure to entrepreneurial activities, and more support for venture start-ups. This will enhance the individual's ability to seize opportunities.

Finally, the Networking pillar also consists of two variables, connectivity and know Entrepreneurs. Japan has no defect in connectivity institutional variables, which expected from a civilised country with a robust infrastructure. Nevertheless, the drawback in the individual variable Know Entrepreneurs that scores only 21%, shows the proportion of the people who personally know an entrepreneur who began a business within two years (Ács *et al.*, 2017). The low score can be attributed to Japan's culture, individual culture, and limited respect to entrepreneurship as a career choice (Martin, 2019; Shinato *et al.*, 2013). Possibly we can approach this by increasing the exposure of society to entrepreneurs' stories, and their role in society and the economy; this will improve society's respect for entrepreneurs. Also, through international and local conferences targeting young people, to introduce domestic and foreign entrepreneurs to share their experiences and ideas. This approach can help Japan in building a more effective and powerful network between entrepreneurs in Japan and outside Japan.

## CONCLUSIONS

The fundamental purpose of the paper is to investigate the entrepreneurial development in Japan and suggest some recommendations that can help in enhancing its entrepreneurial performance. We used the GEI methodology to examine the country's development at the institutional and individual levels. Also, we used the PFB methodology to suggest policy recommendations by highlighting the worst-performing pillar in the system.

Based on the multi-level analysis, we found Japan's performance to be modest compared to other countries in the same region as Japan is listed in the 26th place in the global rankings after Hong Kong 11th, and Taiwan 16th. Hong Kong profile surpasses Japan profile in the attitudes sub-index. Japan should follow the lead of Hong Kong and Taiwan, especially in the attitudes related pillars. The cause for the modest performance is the population characteristics such as perception, motivation, and attitude toward entrepreneurship. Where Japan is among the worst countries (worst 25%), in six individual variables, and has only three variables in the best 25%, where the average score in the all individual variables is only (0.51). On the other hand, almost all of Japan's institutional variables are among the best 25% countries, and three variables in the best 50% countries, which is expected from an innovation-driven economy. These findings suggest that the focus should be on the individual variables, especially in entrepreneurial attitudes sub-index.

We used a novel implication of GEI, the PFB methodology; we were able to simulate a situation where Japan can improve its GEI average scores by 10 points through targeting the weakest pillars. Based on the PFB analysis, Japan has three main bottlenecks, opportunity perception, start-up skills, and networking which are all in the entrepreneurial attitudes sub-index. To improve Japan's GEI scores by 10 points, this call for directing 50% of total effort (entrepreneurship policy resources) in the opportunity perception, 39% in Start-up skills, and 11% in the networking pillars.

As a limitation, the GEI data used in the analysis covers only the 2012-2016 period. Therefore, further analysis is needed to cover a more extended or more up-to-date period than the one used in the study, especially since there was a change in the Japanese government and policies during the period 2012-2013. We compared the Japan profile only

with Hong Kong and Taiwan and only at the level of the pillar. Accordingly, more comparison should be made with various countries outside East Asia, at all levels. Additionally, GEI is a good indicator to be used for start-up companies.

Despite the limitation, the article contributes to portraying Japan's entrepreneurial profile through a unique index that combines quality-related individual and institutional variables in a single model. We contribute to identifying the weak aspect in Japan's entrepreneurial profile at the sub-index, pillars, and the level of the variables. In particular, the analysis presents empirical evidence that the ground for the modest performance is due to the shortage of population entrepreneurship traits. Adding to that, we used the PFB approach to highlight the country's bottlenecks and to provide approximate suggestions on how much Japan seeks to improve its bottleneck.

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# The nexus between Indonesia's exchange rate and the world crude palm oil price

Cheng-Wen Lee, Andrian Dolfriandra Huruta

## ABSTRACT

**Objective:** International trade plays a major role in increasing the output of each country. Crude Palm Oil (CPO) is one of Indonesia's major export commodities. Facts show over the past two decades, CPO has become a fast-growing product. However, there are obstacles from one of Indonesia's CPO importers, namely the European Union. The aim of this study is to explore the nexus between the exchange rate and the world price of CPOs.

**Research Design & Methods:** This study uses both the exchange rate of Indonesia and the price data of the world CPO from 1981-2017 as secondary. Granger Causality was used to explain the nexus between the exchange rate and the world price of CPOs.

**Findings:** The results of the Granger Causality showed there was no causality between the exchange rate and the price of the world CPO. The lack of causality between the two variables suggests the trade balance's position is stronger and able to explain the exchange rate.

**Contribution & Value Added:** This study indicated that the IDR exchange rate is more sensitive to trade balance rather than the world CPO price. Moreover, it is necessary to refined palm oil products to increase the contribution of the non-oil sector in Indonesia. In addition, the Indonesian government needs to be aware of the European Union's raised barriers to world trade. It means that Indonesia can make a positive campaign about the advantages of palm oil production.

**Article type:** research paper

**Keywords:** International Trade; Crude Palm Oil, Exchange Rate; World CPO Price; Granger Causality

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## INTRODUCTION

Crude palm oil (CPO) is one of the oils with the highest production and consumption in the world (Aprina, 2014; Ashfahany & Priyatna, 2015; Buyung, Sychalad, Masbar, & Nasir, 2017). In Asia, Africa, and South America, the majority of crude palm oil is produced. Indonesia and Malaysia dominate the global production of crude palm oil (Indonesia Investments, 2017). These two countries contribute about 85 to 90% of the total global production of palm oil. It can be recalled that 2018 was the year when Indonesia's national crude palm oil production rose to 42 million tons, while Malaysia crude palm oil production as 19.5 million tons (The Star, 2019). As we know that China, the European Union, Africa, India, the Middle East, and Pakistan are historically the major markets for Indonesian crude palm oil (The Palm Scribe, 2019).

In addition, CPO is one of the major export products from the plantation industry in Indonesia. As a major resource, CPO can also contribute to Indonesia's overall gross domestic product from 1.5 percent to 2.5 percent (Indonesia Investments, 2017). CPO also accounts for 30% of the total export revenue generated by the non-oil sector in its contribution to export revenue (Ashfahany & Priyatna, 2015). It can be understood that the export value is associated with the price of the CPO. World CPO price would impact other countries' markets for exports of CPOs. As the largest palm oil producer and exporter of palm oil, Indonesia must be able to make changes to the world CPO price level.

As a country with a floating exchange rate system, Indonesia hands over the determination of the IDR (Indonesian Rupiah) exchange rate to the market (e.g., demand and supply of IDR). Therefore, many factors can influence exchange rate movements and one of them is the condition of international trade. International trade will be represented by exports or imports. As one of Indonesia's export commodities, CPO will be an important part of international trade and will also have an impact on the IDR exchange rate as a transaction tool (Aprina, 2014). The previous study indicated that world CPO price will affect the exchange rate of a country (Amano & Van Norden, 1998; Ashfahany & Priyatna, 2015; Aziz & Applanaidu, 2017; Buyung *et al.*, 2017; Edwards, 1986; Huda & Widodo, 2017; Iqbal, Hameed, & Devi, 2012; Kohlscheen, Avalos, & Schrimpf, 2016). Conversely, the previous study showed Granger Causality tests do not find any evidence that commodity prices Granger-cause exchange rates (Chen, Rogoff, & Rossi, 2010). Furthermore, the exchange rate does not have causality with some commodities (Saiti, Ali, Abdullah, & Sajilan, 2014). In addition, Chan, Tse, and Williams (2011) stated that commodity returns do not share with currency returns causal relationships. Commodity prices and exchange rates are closely linked, but within one day the lead-lag relationship disappears. Based on the above-mentioned arguments, we can see the fluctuation of the world CPO price from 1967-2017.

Based on the above-mentioned arguments, this study has identified the nexus between Indonesia's exchange rate and the world crude palm oil price. The time-series analysis is used to apply the model to various testing procedures such as stationary test, cointegration test, lag length test, and Granger Causality test. The observation period starts from 1981-2017, which includes the policy related to national private estate credit & people's core-transmigration plantation, Indonesia's financial crisis in 1998, the global financial crisis in 2007-2008, and the non-tariff barriers imposed by the European Union since 2011 until the present.

The rest of the article is arranged according to the following sections. In the next section, we present a literature review and theory development. Next, we present materials and methods. Then, we present findings of the analysis results. Afterwards, we discuss the findings and in the last section we provide a conclusion and as well as present the implications for government policy and future research.

## LITERATURE REVIEW

Several studies were done related to the nexus between the exchange rate and crude palm oil price. Buyung *et al.* (2017) using Vector Autoregression (VAR) proved that world CPO prices (Rotterdam) affect the exchange rate of IDR/US\$ and world soybean oil prices which are CPO substitution items (Amano & Van Norden, 1998; Aprina, 2014; Aziz & Applanaidu, 2017; Bodart, Candelon, & Carpentier, 2015; Cashin, Cespedes, & Sahay, 2004; Edwards, 1986; Kiatmanaroch & Sriboonchitta, 2014; Kohlscheen *et al.*, 2016). The increase in the IDR exchange rate will affect the price of some commodities and affect the CPO export prices in Indonesia. However, Ashfahany and Priyatna (2015) using the Error Correction Model (ECM) proved a long-term negative and significant relationship from CPO prices to Indonesian (IDR) and Malaysian (RM) exchange rates. In addition, Zou, Zheng, and Li (2017) also proved commodity prices in Australia and New Zealand have the ability to predict future exchange rates.

In countries that adhere to the floating exchange rate system (e.g. Australia, Canada, New Zealand, South Africa, and Chile), the previous study was also conducted. The floating exchange rate shocks the country's commodity prices (Chen *et al.*, 2010). Malaysia also experienced unusual things related to palm oil commodity prices and the exchange rate, according to Saiti *et al.* (2014). There was no lag-lead relationship between the 1990-2012 period that could affect one factor with another variable between the exchange rate and the palm oil price (Chan *et al.*, 2011; Chen *et al.*, 2010; Saiti *et al.*, 2014). The findings of the wavelet cross-correlation study will explain it. The different levels did not demonstrate the causality between the exchange rate and the oil palm commodities price.

In this article, we refer to the Balassa-Samuelson model. The model of Balassa-Samuelson is important to explain the relationship between the exchange rate and a commodity's relative value. This model identifies important factors that explain the relationship between exchange rates and relative prices (e.g., productivity growth) (Asea & Corden, 1994). Thus, prices have risen in the non-traded goods sector. So it has an indirect impact on a commodity's price. Nevertheless, when prices increase in the non-traded sector, they will not be responded directly to the consumer. The sticky cost and wage model works in this situation. Therefore, commodity prices will rise that can be exchanged and trigger exchange rate appreciation (Chan *et al.*, 2011). An increase in the productivity of CPO, especially in Indonesia, will be able to increase the price of CPO itself. The CPO price that tends to rise will increase the IDR exchange rate as demand for the IDR will also rise (Cashin *et al.*, 2004).

Shiozawa (2017) also stated that the distinction between tradable and non-tradable products is relevant in the arguments concerning the Balassa-Samuelson model. There are no intrinsic properties but the difference between tradable and non-tradable products. The cost of transportation that makes certain goods tradable and some non-tradable. Indeed, if the cost of transporting goods between countries is always above the minimum difference in the cost of production, then such a good is will not be traded. On

the other hand, when the transportation costs (including transaction costs and tariffs) are minimal, there are small differences in price particularly the good that will be traded between countries. Therefore, when the cost of transportation falls to a small proportion of the original cost, most previously non-tradable goods become tradable and would be exchanged in turn (Shiozawa & Fujimoto, 2018).

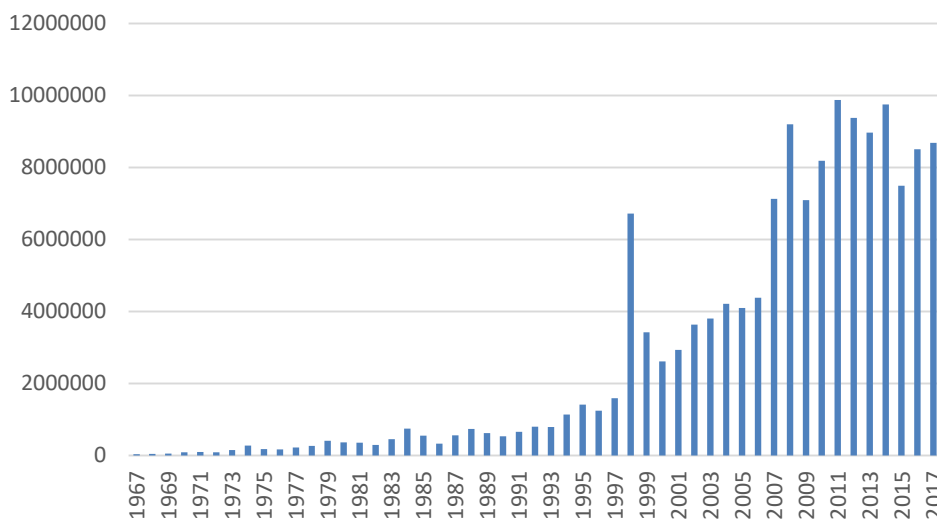
International trade will certainly be close to the activities of exports and imports. A nation can trade with another country if there are variations in the cost of production and relative prices in exporting the products of the country with other countries (Shiozawa, 2015). In addition, if the opportunity cost of the country is lower in producing goods and if vice versa, a country will export (Pugel, 2016). Primary goods or goods that are the main commodities in a country (such as CPO in Indonesia) will be emphasized for export. According to Kahn (1984), the price of a commodity can be formed from the intersection between aggregate demand and aggregate supply (long term and short term). Every country must have a reliable commodity. Mainstay commodities will be used to show the existence of countries in international trade. According to Delle Chiaie, Ferrara, and Giannone (2017), global commodity exchange and involving many parties requires strong institutions and regulations. This is necessary to maintain the price of each commodity traded on the international market. Many factors can influence the movement of the demand and supply side of a commodity. One factor that is capable of influencing commodity price is global factors (Delle Chiaie *et al.*, 2017). Global factor in terms of global demand side is able to vary prices and is strongly related to current economic conditions. In addition, Arango-Thomas, Arias-Rodríguez, and Flórez (2008) stated real interest rates also play an important role and are able to influence commodity prices in a country.

Moreover, the real exchange rate is one country's relative price level against another country and is a marginal exchange rate shift. The exchange rate structure also varies from every country (Zuhroh & Kaluge, 2007). There are two types of exchange systems, the floating exchange rate, and the fixed exchange rate. A floating exchange rate is a system of exchange rates that do not have any party's interference and its price is left entirely to the foreign money market. On the other hand, the exchange rate remains closely linked to internal party (state) interventions (Pugel, 2016). Various factors can also affect a country's currency exchange rate. Exchange rates can be influenced by internal monetary variables such as real interest rates and production differentials (Kakkar & Yan, 2014; Pugel, 2016). However, Kakkar and Yan (2014) reported that exchange rates can also be affected by external factors such as real gold prices representing the shock state of the global economic system.

## MATERIAL AND METHODS

Figure 1 showed fluctuations in world CPO prices always occur every year. However, it is more likely to increase (e.g., positive trends began to occur in the 1980s). This condition occurs because of policies to facilitate the production of CPO in the form of National Private Estate Credit (*PBSN: Perkebunan Besar Swasta Nasional*) and the People's Core-Transmigration Plantation (*PIR-Trans: Perkebunan Inti Rakyat-Transmigrasi*). On the other hand, the IDR exchange rate against the US\$ tends to weaken or depreciate. In 1998 there was a very significant change in both variables due to the monetary crisis that hit Indonesia. After the monetary crisis, Indonesia faced a number of obstacles which finally suppressed demand for CPO exports from Indonesia. When there was an

appreciation of the IDR exchange rate, the European Union (as an Indonesian CPO importer) suddenly issued non-tariff barriers (e.g., 2011 until present). The non-tariff barriers imposed by the European Union are noted in the EU Directive policy. The application of CPO standardization entering the European Union due to the issue of Indonesian CPO which is not environmentally friendly (Sally, 2016). Certainly, the phenomena will affect the decline in demand from CPO exports and the IDR, which will lead to a fall in CPO price. According to Edwards (1986), the changes in the price of an export commodity will have an important effect on the country’s exchange rate.



**Figure 1. The World CPO Price from 1967-2017**

Source: The World Bank (2018a).

### Time-Series Analysis

Annual time-series data were obtained from the World Bank from 1981-2017. The two variables include the exchange rate of IDR to US\$ and the world CPO price. Statistical testing in this study begins with a stationarity test (Winarno, 2015).

$$Y_t = \alpha_1 + \alpha_2 + \delta\beta X_{t-1} + \delta\beta Y_{t-1} + e_t \tag{1}$$

where:

**H0:**  $\delta = 0$  (series has not stationary);

**Ha:**  $\delta \neq 0$  (series has stationary).

In addition to the stationary test, the Cointegration test can be carried out through the Johansen Cointegration test (Rosadi, 2012).

$$Y_t = \alpha_{1t} + \delta X_{1t} + e_t \tag{2}$$

$$X_t = \alpha_{2t} + \delta Y_{1t} + e_t \tag{3}$$

Furthermore, a lag length test is needed to find the optimal lag (Lütkepohl, 2005). The modification of the sequential likelihood ratio (LR) experiment is done as follows.



Starting from the maximum lag, use the  $\chi^2$  statistics to test the hypothesis that the lag  $l$  coefficients are jointly zero.

$$LR = (T - m)\{\log|\sum \epsilon, l - 1| - \log|\sum \epsilon, l|\} \sim \chi^2(k^2) \quad (4)$$

Equation 4 revealed that  $m$  is the number of parameters per equation under the alternative. Remember that we use the small sample modification of Sims (1980) which uses  $(T - m)$  instead of  $T$ .

While the Granger Causality test can be developed after the optimal lag length test is determined (Rosadi, 2012). The Granger Causality test is a statistical test of inference to determine if a one-time series is useful for forecasting. The Granger Causality test is such a technique to check the path of the nexus between the exchange rate of Indonesia and the world price of crude palm oil. Granger Causality's model can be seen in Equation 5 and 6 below.

$$Y_t = \alpha_1 + \sum_{i=1}^m \beta_i Y_{t-i} + \sum_{j=1}^n \gamma_j X_{t-j} + \mu_t \quad (5)$$

$$X_t = \alpha_2 + \sum_{i=1}^p \phi_i X_{t-i} + \sum_{j=1}^q \psi_j Y_{t-j} + \eta_t \quad (6)$$

There are four hypotheses to explain the causality between the IDR exchange rate and the world CPO value based on Models 5 and 6.

- H1:** Unidirectional Granger Causality from world CPO price to the IDR exchange rate  $\sum_{j=1}^n \gamma_j \neq 0$  and  $\sum_{j=1}^q \psi_j = 0$ .
- H2:** Unidirectional Granger Causality from the IDR exchange rate to world CPO price  $\sum_{j=1}^n \gamma_j = 0$  and  $\sum_{j=1}^q \psi_j \neq 0$ .
- H3:** Bidirectional Granger Causality from the IDR exchange rate to world CPO price and vice versa  $\sum_{j=1}^n \gamma_j \neq 0$  and  $\sum_{j=1}^q \psi_j \neq 0$ .
- H4:** Independence between IDR exchange rate and world CPO price  $\sum_{j=1}^n \gamma_j = 0$  and  $\sum_{j=1}^q \psi_j = 0$ .

The model was tested by F-tests particularly the probability values for F statistics on lagged values of the exchange rate in Indonesia and with lagged values for such the world crude palm oil prices. While the calculations in this study were made with the software of the EViews 10 version.

## FINDINGS

We provide results of analysis such as stationary testing, testing for cointegration, testing for the lag length, and causality of Granger. Table 1 below shows the stationary test results.

Table 1 showed the exchange rate series having the ADF-test statistic (-0.575422) smaller than the critical value (-2.943427). It indicated the series has no stationary. However, when the series is transformed into the first difference order, the value of the ADF-test statistic (-7.158927) becomes larger than the critical value of 2.945842). Therefore, it can be indicated that the series is stationary at the first difference order (D(ER)). Similarly, the world CPO price has an ADF-test statistic (-0.555129) lower than the critical value (-2.943427). It indicated the series also have no stationary. However, when the series is transformed into the first difference order, the value of the ADF-test statistic (-7.151087)

becomes larger than the critical value (-2.945842). Therefore, it can be indicated that the series is stationary at the first difference order (D(CPO)).

**Table 1. Stationary test results**

Variable	$\alpha$	ADF-test statistic	Critical value	Conclusion
ER	5%	-0.575422	-2.943427	Series has no stationary
D(ER)		-7.158927	-2.945842	Series has stationary
CPO		-0.555129	-2.943427	Series has no stationary
D(CPO)		-7.151087	-2.945842	Series has stationary

Noted: ER implies the exchange rate; D(ER) implies the exchange rate at the first difference order; CPO implies the world CPO price; D(CPO) implies the world CPO price at the first difference order.

Source: own study.

**Table 2. Cointegration test results**

Hypothesized	Trace Statistic	0.05 Critical value	Conclusion
None	27.25539	15.49471	Cointegrated
At Most 1	4.454253	3.841466	Cointegrated

Source: own study.

Table 2 showed that a long-term relationship existed between the exchange rate and the price of the world CPO. Trace statistical value on hypothesis none as 27.25539 and hypothesis at most 1 as 4.454253 which is larger than the hypothesis critical value none (15.49471) and hypothesis at most 1 (3.841466).

**Table 3. Lag Length test results**

Lag	LogL	LR	FPE	AIC	SC	HQ
0	-616.2567	NA	2.07e+14	38.64104	38.73265	38.67141
1	-604.6103	21.10919*	1.29e+14*	38.16314*	38.43797*	38.25424*
2	-603.3801	2.075961	1.54e+14	38.33625	38.79430	38.48808
3	-602.3122	1.668485	1.86e+14	38.51951	39.16077	38.73207
4	-601.6602	0.937269	2.33e+14	38.72876	39.55324	39.00205
5	-600.5848	1.411447	2.88e+14	38.91155	39.91925	39.24557

\* Indicates the optimal lag.

Source: own study.

Table 3 showed that the best lag to explain a variable’s effect on the past of this variable and other endogenous variables is lag 1. Therefore, to run the Granger Causality, lag 1 is sufficient.

**Table 4. Granger Causality test results**

Null Hypothesis:	Obs	F-Statistic	Prob.
D(ER) Does not Granger Cause D(CPO)	36	0.39820	0.5324*
D(CPO) Does not Granger Cause D(ER)		0.37542	0.5443*

\* Accepted Null Hypothesis

Source: own study.

Table 4 showed that the exchange rate (D(ER)) and the world CPO price (D(CPO)) are not causal. The results of Granger Causality are understood to have accepted the null hypothesis (independence between the exchange rate of IDR and the world CPO price). Acceptance of the null hypothesis is based on values of probability as 0.5324 and 0.5443 which are larger than critical values (5%).

## DISCUSSION

The results of Granger Causality test support hypothesis 4 that the IDR exchange rate and the world CPO price are independent (there was no causality between Indonesia's exchange rate and the world crude palm oil price). Our findings supported by Chen *et al.* (2010) and Chan *et al.* (2011) that there was no causality between exchange rate with commodity price. However, the commodity price fluctuations are typically more sensitive to short-term demand imbalance. There was similar research that works in Indonesia such as Saiti *et al.* (2014) that proved there was no causality between commodity price and exchange rate. However, they revealed the exchange rate is more sensitive to stock price (Pandya, 2016) rather than the commodity price. Still in Indonesia, Aprina (2014) argued that the CPO's global value directly and indirectly through the financial market influences the exchange rate. It can be understood that the higher price of CPOs results in an appreciation of the real rate of Rupiah. Therefore, the higher world price of CPO will increase domestic inflation, which will also increase the rate of Rupiah. In addition, there was a significant effect on the money supply (Nwosa, 2017; Omolade & Mukolu, 2018) and with a positive sign of the domestic value of the CPO (Edwards, 1986). It means that the rising in domestic CPO prices would raise nominal money demand from the public. The current account improvement would increase the foreign exchange, which essentially increases the number of money supply in the country (Nwosa, 2017; Omolade & Mukolu, 2018). The existing gap revealed that the exchange rate more sensitive to short-term demand imbalance (Chan *et al.*, 2011; Chen *et al.*, 2010), the stock price (Saiti *et al.*, 2014), and money supply (Aprina, 2014).

Further, our findings were not supported by the Balassa-Samuelson model (Shiozawa, 2017; Shiozawa & Fujimoto, 2018). When the prices have risen in the non-traded goods sector, there was no impact on commodity prices to Indonesia's exchange rate. According to Ahmad (2014), although it has a long-term impact, the world CPO price has not been able to cause an exchange rate. It can be understood that there has been a larger influence on international trade from other factors compared to one of the key products of the world. The trade balance is one of the variables that the exchange rate can affect (Dogru, Isik, & Sirakaya-Turk, 2019; Doukas & Lifland, 1994; Ghosh, 2010; McKinnon, 1990; Zuhroh & Kaluge, 2007).

The trade balance is an overview of the conditions of a country's export and import activities. The trade balance is determined by the difference in the price of the exports and imports of a nation (e.g., Indonesia) (Zuhroh & Kaluge, 2007). It can be noted that exports from Indonesia outweigh imports and vice versa when the trade balance has a surplus. As Indonesia's trade balance rises, it reflects an increase in exports from Indonesia at the same time. The rise in Indonesian exports will boost the exchange rate in Indonesia. Empirically, the results of this study could not explain the direction of a definite relationship between the two variables (the exchange rate and the price of the world

CPO). Nonetheless, the strengthening of the conditions of the exchange rate can ultimately determine the status of Indonesia's trade balance (Zuhroh & Kaluge, 2007).

Figure 2 showed the IDR exchange rate fluctuates with the trade balance trend. When the trade balance experienced a larger surplus, it was also followed by a stronger exchange rate (Zuhroh & Kaluge, 2007). The situation tends to occur between 1981 to 2017. However, it is more clearly seen after the monetary crisis (1998). In 1998 Indonesia used a floating exchange rate system from previously using a fixed exchange rate system. Differences in trends only occurred from 1997 to 1998 during the monetary crisis (Aprina, 2014; Zuhroh & Kaluge, 2007). The exchange rate weakened drastically. However, at the same time, the trade balance experienced a surplus. It can be understood that the prices of Indonesia's exported goods tend to be cheaper (Aprina, 2014). This condition is more supportive of how the IDR exchange rate actually works. The price of one commodity is not enough to affect Indonesia's exchange rate. However, the export and import positions in the aggregate are able to explain the condition of the IDR exchange rate and vice versa (Dogru *et al.*, 2019; Doukas & Lifland, 1994; Ghosh, 2010; McKinnon, 1990; Zuhroh & Kaluge, 2007).

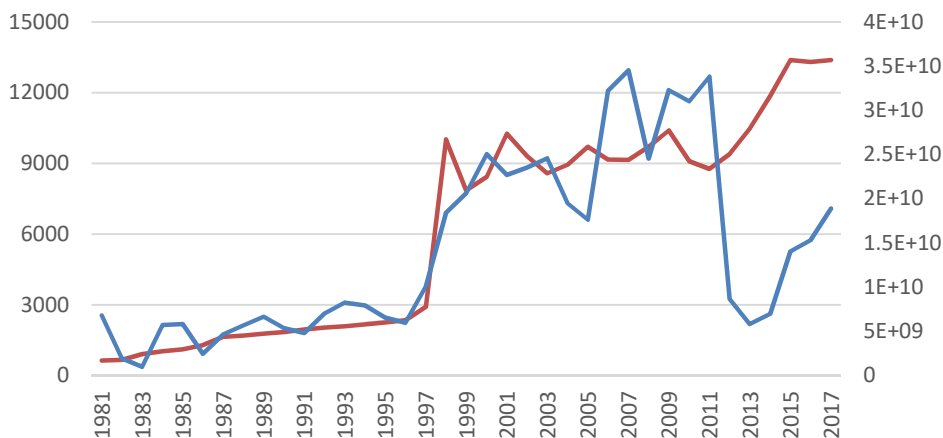


Figure 2. Exchange Rate dan Indonesia's Trade Balance from 1981-2017

Source: The World Bank (2018b).

### CONCLUSIONS

Palm oil is one of the world's most widely produced and consumed oils. Indonesia is the largest producer and exporter of palm oil in the world, but it is also the largest greenhouse gas emitter after China and the United States. Nevertheless, palm oil is a major pillar of the economy of Indonesia. Based on the Granger Causality test we have proved that there is independence (no causality) between IDR exchange rate and the world CPO price. The absence of causality between the two variables indicates the influence of international trade (the trade balance) which is stronger and able to explain the exchange rate (Dogru *et al.*, 2019; Doukas & Lifland, 1994; Ghosh, 2010; McKinnon, 1990; Zuhroh & Kaluge, 2007). Therefore, it is necessary to increase the value-added (Pandya, 2016) in Indonesia's processing of CPOs. It is aimed to increase the contribution of the non-oil

sector. In addition, the Indonesian government needs to be aware of the European Union's raised barriers to world trade. In other words, Indonesia can make a positive campaign about the advantages of palm oil production.

Our findings become important for the Indonesian government as the world's largest palm oil producer. It also contributes to the literature on crude palm oil's development in Indonesia. We are reinforcing the previous research by Zuhroh and Kaluge (2007) related to the relationship between exchange rate and trade balance rather than Saiti *et al.* (2014) (the stock price) and Aprina (2014) (money supply).

Due to the current limitations, the Granger Causality was unable to clarify both the exchange rate and the world CPO price in the form of a specific relationship. Several models like Panel Data, Vector Autoregression (VAR) and Structural Vector Autoregression are appropriate to explain the causality between the exchange rate and the world CPO price. In addition, future research may consider the multivariate causality between trade balance, money supply, and stock price to explain the fluctuations in the exchange rate in Indonesia.

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## Patterns of internationalisation of Finnish SMEs in Estonia: Preliminary survey results

Faisal Shahzad

### ABSTRACT

**Objective:** The objective of this paper is to look at the patterns of the internationalization process of Finnish SMEs and how it fits the internationalization models. Discussions are based on the interrelated theories of internationalization specifically the Uppsala model, Network approach and Models of International Entrepreneurship. This work also presents an intense analysis of the level of internationalization among SMEs, the mode of entry, motives and barriers for internationalization.

**Research Design & Methods:** The empirical research was carried out in the period of January 2018-August 2018. Data were collected through a mail survey questionnaire and 121 usable responses were received. The data was then analyzed in SPSS software by the cross-tabulation method to achieve the results.

**Findings:** Findings indicate that the majority of Finnish SMEs that started international operations follow a step-by-step approach of internationalization. Exporting was a major mode of entry into foreign markets, capturing market share was the main motive, and lack of market knowledge was a major barrier for internationalization.

**Contribution & Value Added:** It is confirmed that Uppsala, Network and Entrepreneurship models are still valid, and majority of Finnish SMEs follow the systematic internationalization process. This study contributes to the internationalization process of SMEs and calls for further comparative research in other markets to validate the results. It is confirmed that there is no single theory, which explains the internationalization process of SMEs and this work provides the threshold for theory development.

**Article type:** research paper

**Keywords:** exporting, internationalization theories, models of international entrepreneurship, network approach

**JEL codes:** F23, L26

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## INTRODUCTION

Small and medium-sized enterprises (SMEs) play an important role in the economic growth of the countries and consequently, the internationalization process of SMEs has become a subject of academic, political, and governmental attention and research (Oviatt & McDougall, 1994). Due to a reduction in trade barriers and tariffs, regional economic integration and World Trade Organization (WTO), together with the development of information and communication technology provide the opportunity for small and medium enterprises (SMEs) to expand their business into foreign markets and increased their revenues (Ripolles, Blesa, & Monferrer, 2012). Erramilli and D'Souza (1993) argued that what distinguishes SMEs from large multinationals enterprises (MNEs) are their managerial style, ownership, and independence and furthermore, their limited resources may lead them to very different international strategic choices in contrast to large firms (Zacharakis, 1997).

The motives for internationalization are given numerous names by different authors in the wider literature “motives” (Alexander, 1997), “triggering cues” (Wiedersheim-Paul, Olson, & Welch, 1978), “facilitating factors” (Treadgold & Gibson, 1989), “influence of imitation, network position, and international experience” (Oheme & Bort, 2015), “factors influence the choice of internationalization” (Doherty, 2009), “internationalization process” (Oviatt & McDougall, 1995; Wolff & Pett, 2000). These studies examine the characteristics of SMEs, their motivation for international growth; entry mode selection, barriers or obstacles of internationalization. Later, entry mode decision is considered such an important strategic decision and the success of SMEs depends on the preparation and execution of strategy (Knight, 2000). In brief, it remains challenging for many SMEs to internationalize successfully and what are the main factors which affect the entrance of SMEs into foreign markets (Chang & Yu, 2008).

This study sheds the light on the pattern of the internationalization process of Finnish SMEs and how it fits within different models. Hence, the objective of this article is to look at major internationalization theories suggested by numerous researchers (Burgel & Murray, 2000; Oviatt & McDougall, 2005) and to shed the light on which theory or framework explains the internationalization practice of Finnish SMEs in the best way. The second objective is to upsurge the understanding of the behavior of Finnish SMEs in the context of internationalization.

Patterns of internationalization of SMEs must be investigated and, in this investigation, author chooses Finnish SMEs, which have operations in Estonia. We can conclude whether they follow systematic internationalization process or rapid internationalization and what are the motives and barriers of internationalization by examining the behaviour of Finnish SMEs. In order to achieve the main objective of this study following research questions have been formulated:

- RQ1:** What are the main motives to internationalization for Finnish SMEs?
- RQ2:** What are most suitable entry modes starting a business in a foreign market?
- RQ3:** What are the barriers to internationalization for Finnish SMEs to expand the business in foreign markets?

According to Carter and Jones-Evans (2006), there is no single definition of small enterprises. In this study, the European Commission's recommended definition for small and me-

dium-sized enterprises has been followed. According to the European Commission (2003) “enterprises qualify as micro, small and medium-sized enterprises if they fulfil maximum ceilings for staff headcount and either a turnover cap or a balance sheet ceiling” (p. 39).

### THEORIES OF INTERNATIONALIZATION

Scholars and academics have described the internationalization concept numerous times using many different perceptions and variables. The term ‘internationalization’ is indefinite, and its definitions vary depending on the occurrence they include. According to Penrose’s (1959) internationalization mainly focuses on the firm’s core competencies and opportunities in the foreign environment. Welch and Luostarinen (1988) defined internationalization as the process by which firms increase their involvements in international operations. Afterward, Calof and Beamish (1995) defined internationalization as “the process of adopting firms’ operations (strategy, structure, resource, etc.) to global environments” (115-131). This paper will highlight three frequently cited internationalization theories, known as the Uppsala model, Network theory, and Models of international entrepreneurship.

*Uppsala model* aimed to clarify how firms expand their operations in foreign markets and meanwhile how their resource commitment increase. The theory describes foreign market choice and explains other foreign direct investment (FDI) choices as well (Johanson & Vahlne, 1977, Luostarinen, 1979). Uppsala model has two dimensions: “market commitment” and “market uncertainty.” Market uncertainty states that there can be several changes in the future due to high competition, industry decline, political stability etc. This framework illustrates that due to the lack of market knowledge firms avoid entering into the foreign market through foreign FDI mode and adopt less risky entry mode (export). A firm may select FDI mode or higher market commitment modes at the time of entry if the foreign market is growing or have a huge potential of growth. (Johanson & Wiedersheim-Paul, 1975). Several academics have initiated it unacceptable in some cases while some others accepted it with amendments. Moreover, this model is predominantly suitable for firms at the early stages of internationalization or have limited resources (Shahzad, & Elenurm, in press). On the other hand, a quick change in technology and today’s level of globalization might have changed this internationalization theory into an inadequate model for the mainstream of today’s firms.

Johanson and Vahlne (2009) reviewed their previous internationalization model by applying a basic networking overlook. The following figure shows the main element and changings in their revised model. Uppsala revised model sheds the light on state and change variables and their impact on each other. The first variable illustrates opportunities, which exist besides the knowledge, and the second variable is inside the model position of the network. The Network position plays a significant role in the internationalization process. There are several activities e.g. learning, trust building, knowledge sharing, creating synergy through cross borders teams and these are the changing aspects of this new version of the Uppsala model (Johanson & Vahlne, 2009). The state and changing dimensions of the model deliver an intense interface contrivance to clarify the internationalization process in a network context. Based on this model, firms, which have business operations in foreign countries, try to overcome on lack of knowledge about the foreign market and make sure their operations run smoothly. (Johanson & Vahlne, 2009).

Moreover, this framework validates the internationalization of firms, in a network context, based on the interface of two dimensions include state and change.

*Network theory* argues that modern high-technology firms do not follow systematic internationalization process; rather they attain an earlier internationalization through the organizational experience and strong bond with several partners in local and foreign markets. (Mitgwe, 2006). Nowadays firms facing high competition due to the advancement of technology, open borders, ease of doing business, and open trade contract among the nations. Emerson (1981) argues that network is a set of different connected business relationships, in which each interchange relation is between business firms that are intellectualized as cooperative players. Network theorists see the firm's internationalization as a regular expansion from network relationships with foreign individuals and firms (Johansson & Mattson, 1988). The position of the firm in the network (market) is the most significant motive for internationalization. Network position depends on two major elements: Degree of internationalization of the firm, and the degree of internationalization of the network (market). Based on these two elements, four market positions has been introduced for firms: Early Starter, Lonely International, The Late Starter, and International among others (Johanson & Mattsson, 1988). It is established that network-based model's argument quite relevant for born global and international new ventures (INVs) but still Uppsala model is followed by the huge number of firms due to several reasons like limited financial resources, lack of market knowledge, risk and uncertainty, high completion etc. (Shahzad, & Elenurm, in press).

According to Kontinen and Ojala (2011), argue that weak and strong ties and social capital have mainly applied in the context of SMEs. Sharma and Blomstermo (2003) argue that a relationship approaches to focus on network relationship with stakeholders and create synergy for all partners not only for the firms. When firms enter into the foreign market selection of a suitable partner is one of the biggest challenges and therefore, it is used to clarify the selection of foreignmarket and entry mode based on choosing an appropriate partne. Researchers have used them to validate the international opportunity appreciation by entrepreneurial firms, selecting a foreign market by born globalfirms (Prashantham, 2011). Hereafter, network approach provides a narrow down approach specifically in case of SMEs and born globals in order to cope with their limited financial resources, lack of market knowledge, and weak network in foreign market.

The term "*International Entrepreneurship*" (IE) originates from Morrow (1988). He recommended that technological advancements and markets with open borders and cultural awareness provide immense opportunity to firms for global expansion (Oviatt & McDougall &, 2005). Entrepreneurs with a clear global mindset often start born global enterprises and studying them involves appreciative the important transition of procedures, structures, and organizational mindsets at numerous organizational levels (Weerawardena, Mort, Liesch& Knight, 2007). An International new venture has been defined as a "business organization that, from inception pursues to drive substantial competitive advantage from the use of resources and the sale of outputs in several countries" (Oviatt & McDougal, 1994, pp. 45-64). IE research is often regarded as starting with Oviatt and McDougall's (1994) pivotal article on international new ventures (Wach,

2018; Zahra, 2005), which defined the antecedents of as well as the necessary and sufficient conditions for the emergence of born globals (e.g., Madsen & Servais, 1997) or “international new ventures” (INVs)(e.g. Oviatt & McDougall, 1994).

In contrast to the Uppsala model of internationalization, this approach focuses more on rapid internationalization. Also, this theory asserts have described that as internationalization becomes a passion of new entrepreneurs, they possess an immense inclination towards learning and adopting supportive viewpoints, such as innovative ideas, concepts, knowledge, and mechanisms (Collinson & Houlden, 2005). Resource and competency-based theories of internationalization are an important addition to this area of literature. According to IE resources and competencies play an important role in the selection of internationalization strategies. Factors such as financial capability, material capability, and about others, learning capability are determining factors of internationalization. Eventually, the process of internationalization requires the mobilization of resources and competencies in the enterprise (Pantin, 2005; Ruzzier, Hisrich, & Antoncic, 2006). For SMEs to capture the opportunities in the international markets, the entrepreneurial resources, namely the financial and technological resources of the entrepreneur, are important (Dhanaraj & Beamish, 2003). The internationalization process can be influenced by the global vision of the founder, the entrepreneur (Gabrielsson & Pelkonen, 2008). Numerous studies have approved that international entrepreneurial orientation (IEO) is a vital cultural characteristic of born global firms (Knight & Cavusgil, 2004), though there is the second school of thought which believes that IEO is an imminent element of international entrepreneurship theory in general (Wach, 2015). International entrepreneurial orientation is considered a behavioral trait shared by business entities that start out seeking to attain a competitive advantage by expand their business operations in several parts of the world. Table 1 illustrates the comparison view of the above-mentioned models. The table not only sheds the light on main differences of Uppsala, network and IE models but explains main unit of analysis of the models as well.

**Table 1. Comparison of theories**

Uppsala View	Network View	IE View
A development of continuing international engrossment with developing market knowledge and commitment of assets.	Internationalization is the utilization of network benefit. Relationship of a firm can be used as connections to other networks.	Preemptive internationalization procedure and entrepreneurial mind-set and activities in bringing new openings.

Source: own compilation based on literature review.

## ROLE OF SMES IN FINNISH ECONOMY

Historical development shows that Finland’s economy has transformed within a short period from an agricultural economy to a technology-intensive economy (Grönqvist, 2009). Moreover, Nikulainen (2008) argues that Finnish manufacturing and service sectors play a significant role in Finland’s economic development and the manufacturing industry not only evolved with time but introduce highly innovative products. According to Statistics Finland (2016), Finland is much behind in comparison to the other EU Member States with a 239 billion euros GDP rate and ranked 15th out of 28 countries. Finland had 51.8 billion euros of exports and imports were 54.7 billion euros in 2016. According to the Statistics Finland

(2012). SME's contribution was about 385 billion Euros in 2017. Finland has 283,563 enterprises of which 98% are SMEs employing less than 50 people. Moreover, 93.3% of Finnish firms have fewer than 10 employees. Finland's corporate structure has the following composition: 2% are large enterprises and 98% small and medium-sized enterprises. This shows SMEs cover a majestic portion of the corporate structure. The role of SMEs in the Finnish economy and employment is quite significant. SMEs are responsible for more than 36% of Finland's export revenue. As a small and open economy, Finland is very reliant on small and medium-sized enterprises and therefore the role of SMEs in the Finnish economy is crucial.

### RESEARCH METHODOLOGY

Data for empirical analysis were collected via a survey questionnaire during the period of January 2018-August 2018. The population of this investigation is Finnish SMEs, which have international activities in Estonia, and the author chooses SMEs according to European Union definition. Data was collected from 550 SMEs from different industries all over the country. The questionnaire was pilot tested with managers in 8 SMEs who were involved during international expansion into foreign markets. It had been found after conducting the pilot test that there was complete appreciative of the theorized questions and supported our expectations of the manager's capability to answer them correctly and comprehensively. In total, initially 550 questionnaires were mailed: 19 were returned as non-deliverable, which compacted the sample size to 531 questionnaires. Overall, 121 usable questionnaires were received which represents an overall 22.78% present response rate. The data was then analyzed in SPSS software by cross-tabulation method to achieve the results.

### EMPIRICAL FINDINGS

To characterize the respondents, it is necessary to point out that the target audience for collecting data are, CEOs (50%), Managing Directors (37.6%), Business Development Managers (7.4%) and others (5.0%). The majority of the SMEs came from the field of Engineering 27%, Wood products 22%, ICT 21%, Electrical & Electronics 16%, Health care 12%, Rubber Products 11%, and Plastic Products 11%.

Table 3 lists the frequency of SMEs from different industries, which have foreign operations in Estonia. Engineering with 22.51% on the top and followed by Wood 18.18%, ICT 17.75%, Electrical and Electronics 13.47%, Rubber products 9.09, Plastic products 9.09, and Health care 9.91%. There are 51 SMEs have 7-10 year of operations into foreign markets, 43 have 3-6, 16 have 1-2 and 11 have less than 1 year. Moreover, 15.70% SMEs employee 5 people, 38.01% employee 5-25 people, 19.85% employee 26-50 people, 14.87% employee 51-100, 9.09% employee 101-150, and 2.48% employee more than 150.

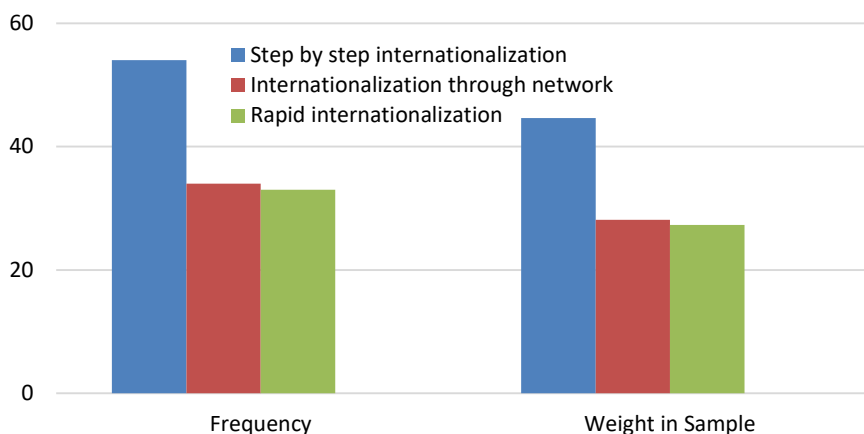
Figure 1 illustrates the internationalization process, where 44.63% highest number of firms used a systematic Uppsala approach for internationalization, while 28.10% of firms mentioned that it utilizes its relations with stakeholders and adapts network approach. On the other hand, 27.27% of firms used rapid internationalization approach.

Figure 2 highlights the key motives of why Finnish SMEs internationalize. It has been found that majestic reason of internationalization was capture market share 42.14% top on the list, which followed by revenue generation/increases in profit 28.11% where 19.85% respondent chose market knowledge, the vision of the owner 9.09% and other reasons are 0.81%.

**Table 2. Characterization of SMEs by industry, year of operations and number of employees**

Industry	Frequency	Weight in Sample
Engineering	27	22.51
Wood and Wood products	22	18.18
ICT	21	17.75
Electrical and Electronics	16	13.47
Rubber Products	11	9.09
Plastic Products	11	9.09
Healthcare	12	9.91
<b>Total</b>	<b>121</b>	<b>100.00</b>
<b>Years of operations</b>		
Less than 1 year	11	9.09
1-2 years	16	13.22
3-6	43	35.44
7-10 years	51	42.25
<b>Total</b>	<b>121</b>	<b>100.00</b>
<b>Employees</b>		
Less than 5 people	19	15.70
5-25	46	38.01
26-50	24	19.85
51-100	18	14.87
101-150	11	9.09
More than 150 people	3	2.48
<b>Total</b>	<b>121</b>	<b>100.00</b>

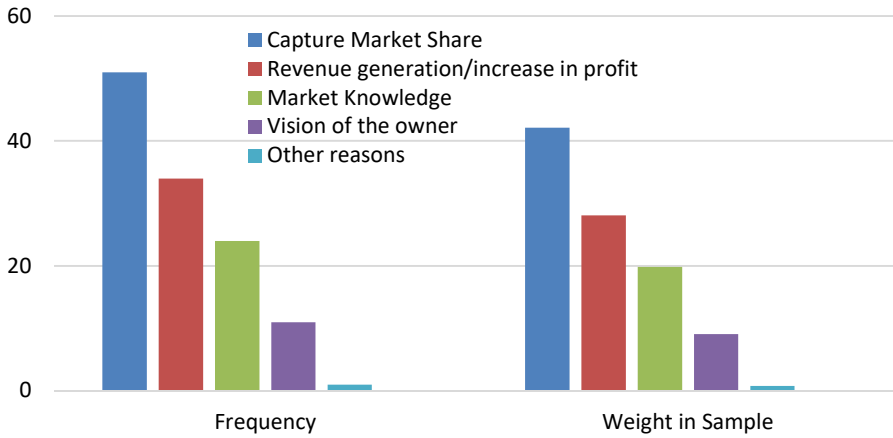
Source: own elaboration based on the survey.

**Figure 1. Internationalization Process of SMEs**

Source: own elaboration based on the survey.

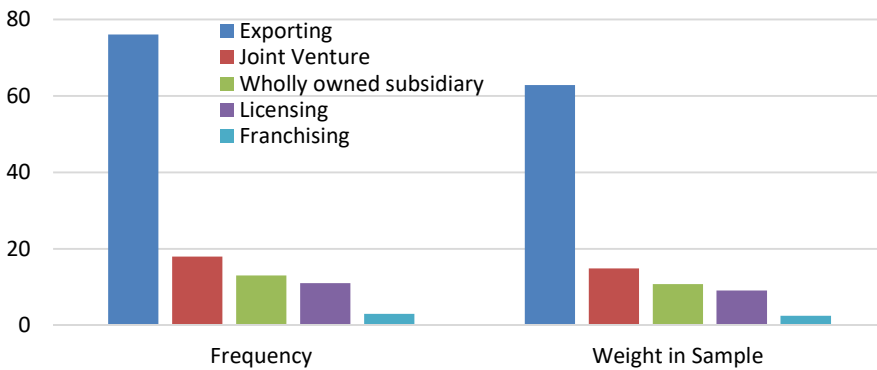
Figure 3 illustrates the terms of mode of entry into the foreign market, exporting is the most popular mode with 62.80%, while other 14.88% choose joint venture, 10.75% choose wholly owned subsidiary, licensing 9.09% and franchising 2.48%.





**Figure 2. Motives of Internationalization**

Source: own elaboration based on the survey.

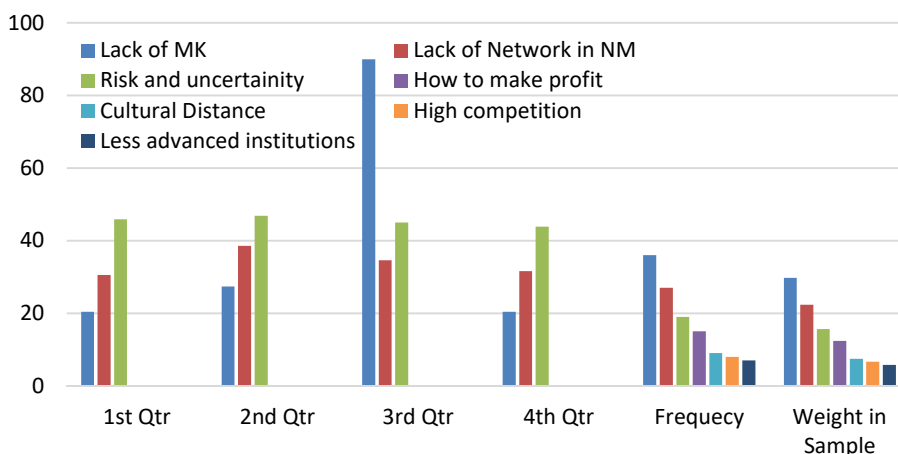


**Figure 3. Mode of Entry**

Source: own elaboration based on the survey.

Figure 4 list out the barriers to internationalization as indicated by respondents of the SMEs. According to results, lack of market knowledge top of the list with 29.75%, following by weak or lack of network in foreign market 22.33%, risk and uncertainty 15.70%, how to make profit 12.39%, cultural distance 7.43%, high competition 6.62%, and less advanced institutions 5.78%.

Next section sheds the light on conclusion, recommendations and direction for future research.



**Figure 4. Barriers of Internationalization**

Source: own elaboration based on the survey.

## CONCLUSIONS

According to data capture, market share was the main reason for internationalization. It is quite clear that the Finnish market is very small and therefore, SMEs must go for other foreign markets for generating more revenues. Finding this investigation is like Abdullah and Zain's (2011) work, which shows that market share and financial success motivate SMEs to internationalize. To obtain this objective SMEs use different methods and strategies when penetrating foreign markets. Shahzad and Elenurm (in press) investigated entry mode strategies of Finnish SMEs and found that firm, country, and industry level variables are significant in the choice of market entry modes. Laufs and Schwens (2014) have conducted a systematic literature review (1986 to 2012) on market entry mode choice of SMEs about explain the theoretical framework applied to explain SME's internationalization. Authors confirm that there is a need to conduct more research on the topic of internationalization of SMEs (e.g., Burgel & Murray, 2000; Jones, 1999; Zacharakis, 1997). Shahzad (2019) investigated Finnish retail SMEs that have an investment in Russia and confirmed that SMEs follow the systematic internationalization process of internationalization. He also argued the main mode of entry was franchises instead of export. The finding of this work differs from the early investigation and provide new insights for an instance, Shahzad and Elenurm (2019), investigated Finnish SME's determinants of market entry mode choice in Estonia and found that firm, country, industry, and institutional environment affect the decision of market entry mode choice. Hessels and Parker (2013) sheds the light on constraints of internationalization for European SMEs and found that having a foreign supplier is a more common internationalization strategy among European SMEs then exporting. Korsakiene and Tvaronavicien (2011) collected the data from 2000 to 2015 on SME internationalization. They have found that the majority of scholars suggested that the main barriers of SMEs internationalization were the unstable legal, political and economic

environment, the lack of knowledge of the foreign market, cultural distance and inappropriate support of the government. Moreover, the important role of the entrepreneur/manager in the internationalization of SMEs has been confirmed by several studies within literature (Reid, 1981) The choice of foreign market entry mode is an important strategic decision for SMEs and complex research issues. According to Calof and Beamish (1995), Chang and Yu (2008,) suggested that SMEs differ their larger counterparts in several ways, which impact important strategic decisions and inappropriate entry mode decision may lead to damages with serious consequences because of their lack of resources.

According to data, a small number of firms adopted greenfield or wholly owned subsidiary as an entry mode due to a highly expensive way to enter into the new market. If we compare the Uppsala model and findings of this investigation then it will be obvious that SMEs use exporting as the first step to enter into the foreign market and it will work as a stepping-stone towards other modes of entry e.g. licensing franchising, joint venture, and wholly-owned subsidiary. The majority of firms pointed out that the reason behind choosing export, as an entry mode, is to avoid risk in the context of financial and market knowledge limitations. On the other hand, there are still many SMEs that adopt the rapid internationalization process instead of systematic expansion due to market knowledge, entrepreneurs experience, abundant financial resources, and product type.

This study sheds the light on a very important element that there is no specific framework or theory, which explains the internationalization process of Finnish SMEs. Uppsala model, Network theory and IE Models are quite relevant when we look into the internationalization process of SMEs, in fact, the Uppsala model is still relevant for SME's context which has been received a lot of criticism recently because not all SMEs are born globals in nature. This study underwrites in a way that it provides significant information for managers of SMEs, entrepreneurs, government institutions, policymakers, through the underlining of vital topics that affect Finnish SME's decision of internationalization. There is very clear evidence that there are several SMEs, which has not started international operations due to a lack of market knowledge, financial resources, and due to weak network connections in a foreign market. These are the areas where Finnish institutions could play a very active role in assisting Finnish SMEs in international expansion. In the present study, efforts have been made to ensure the generalizability of the empirical results, a few limitations of the study must be acknowledged. Overall, this study could not cover all aspects of the internationalization of SMEs. Therefore, the future study may consider investigating the internationalization process of SMEs in specific industries like retail, ICT, manufacturing, wood, etc. in Estonia and then compare the results with other countries as well. Moreover, it would be interesting to investigate the role of different factors in the choice of specific entry modes like culture, institutions, etc. Finally, future studies may investigate why SMEs follow a specific internationalization model and what are the factors, which describe those decisions.

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## The EU-Japan relations: Selected aspects

Andżelika Kuźnar, Jerzy Menkes

### ABSTRACT

**Objective:** The aim of the paper is to prove that in a world where instability is increasing and security is reduced, the EU and Japan are fulfilling their obligation to bear special responsibility for the implementation of the common western values they represent.

**Research Design & Methods:** The research method is based on the critical review of literature and the analysis of source materials (the texts of the Agreements and official documents). We run a policy analysis. We examine the law as a tool for policy implementation (New International Legal Process). We draw conclusions based on them.

**Findings:** The EU-Japan Agreements confirm the community of values on which they are embedded and create conditions for strengthening these values.

**Contribution & Value Added:** The contribution is here that we show the importance of Agreements between the EU and Japan, which stems from both endogenous factors, resulting from economic and political potentials of the Parties; as well as from the exogenous factors, in the form of external determinants of cooperation, such as recent turbulence in US politics.

**Article type:** research paper

**Keywords:** community of values; EU-Japan Economic Partnership Agreement; Strategic Partnership Agreement; Investment Protection Agreement

**JEL codes:** F13, F15, F53, K33

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### INTRODUCTION

We analyze the relations between the EU and Japan through the prism of the following agreements which were signed: Economic Partnership Agreement (EPA), Strategic Partnership Agreement (SPA) and one that is negotiated: Investment Protection Agreement (IPA). EPA liberalizes trade in goods and services. By setting the legal framework for a strategic partnership, SPA enhances political cooperation between Parties. IPA will regulate standards for investment protection and disputes resolution.



The subject scope of the analysis consists of the content of the EU-Japan Agreements; socio-economic and political potential of the parties; EU's legal powers to negotiate and conclude agreements with Japan, and its competence, whether exclusive or shared, to enter into these Agreements; the importance of Agreements for their parties and for other international actors as well as for regional, trans-regional and global relations.

The aim of the study is to prove that in a world where instability is increasing and security is reduced, the parties are fulfilling their, as real great powers, obligation to bear special responsibility for the implementation of the values represented.

We find out that the Agreements confirm the community of values on which they are embedded and they create conditions for strengthening these values.

### THE LITERATURE REVIEW

The Asia-Pacific region is at the forefront of the ranking of regions according to the criterion of conflict potential. This is determined by the co-occurrence of a set of factors, including the number of countries with military nuclear capability and states capable of immediate production of it. In this region there are fallen states, active terrorists, and drugs are produced. The level of danger is enhanced by the fact that North Korea is a contra-system (in relation to a system based on international law). The importance of the region increased after the Cold War, as a consequence of the concentration of nuclear threats in the region, international terrorism, organized crime and significant instability. These threats, in the context of the situation in other regions, determined the American pivot towards Asia. This regional and global policy was named by the Obama administration *pivot to Asia*<sup>1</sup> (Lieberthal, 2011)<sup>2</sup>.

President Trump has rejected this strategy. The change was to include the withdrawal from the transpacific plurilateral agreements in the economic and social sphere, the contestation of cooperation in the sphere of security, undermining the unconditional nature of security guarantees for the countries of the region<sup>3</sup>. The President raised the obligation to participate in the costs of ensuring security (Baker, 2017).

He also rejected the free trade paradigm. It was initiated by the termination of the Trans-Pacific Partnership (TPP)<sup>4</sup>. The decision raised doubts not only as to economic rationality but also to the way international policy was conducted. Unilaterality and brutality demonstrated disregard for the partners. In this situation the USA's announcement of the willingness to conclude bilateral trade agreements with TPP parties disregarded the assessment of the US's ability to conclude international agreements in the assessment of potential parties.

Trump, confronted with the reality, had to quickly give up the declared strategy. Already in November 2017, in a speech at the APEC summit, Trump presented a vision

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<sup>1</sup> This policy was a consequence of the observation made by John Hay, the Secretary of State from 1898 to 1905: "The Mediterranean is the ocean of the past, The Atlantic, the ocean of the present, And the Pacific, the ocean of the future" (Lehmann&Engammare, 2014).

<sup>2</sup> On the other hand, Kolmaš&Kolmašová (2019, p. 61-79) argue that "*pivot to Asia* never really existed". They even named their paper that way.

<sup>3</sup> Directly on the conditionality of the security guarantee see: Sanger&Haberman (2016).

<sup>4</sup> Plurilateral agreement regulating trade relations, signed on 4.02.2016 between: Australia, Brunei Darussalam, Chile, Canada, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, USA and Vietnam. Had it been ratified, it would create the most ambitious free trade deal of the postwar era (Fukushima, 2016).

of a “free and open Indo-Pacific” to strengthen the friendship and trade ties between all Indo-Pacific nations, where trade will be based on “fairness and reciprocity” (White House, 2017a).

Year 2017 closed with a radical turnaround in foreign policy. The National Security Strategy (NSS) presented by the President (White House, 2017b)<sup>5</sup> identifies new, major threats to US security. The source of them is no longer terrorism<sup>6</sup> but great power competition with “revisionist powers”, i.e. China and Russia<sup>7</sup>. The response to Chinese hegemony and the aggressive policy of Russia – the authoritarian states that were considered “strategic competitors” – is to be an army whose potential in the region is to be significantly increased. The decision is based on the recognition that the USA has enduring interests and commitments in the Indo-Pacific region<sup>8</sup>, regardless of financial contributions. The NSS positively assessed the balance of 75 years of cooperation with the allies (in the Pacific and European region)<sup>9</sup>. In the NSS, the US also attached great importance to the cooperation of the Indo-Pacific countries in the new formula of the plurilateral institution – cooperation of four: Australia, India, Japan and the USA.

Democratic Asian and Pacific states and the EU want to be co-creators of the new order. Japan advocated the institutionalization of multilateralism (*de facto* plurilateralism). The withdrawal of the US from the TPP has stimulated the activity of participants of cooperation. An alternative form of institutional economic cooperation was created. On 8 March 2018, 11 countries (TPP minus the US) signed the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP)<sup>10</sup>. However, it is not that the CPTPP is exactly the same agreement as TPP was supposed to be. The ambition of President Obama was to create a (new) pattern of world trade by means of TPP. The TPP consisted of 30 chapters covering – apart from the liberalization of trade in goods and services – everything from labour standards to intellectual property rights. The CPTPP is narrower (22 TPP provisions were suspended), but the agreement proves the parties’ ability to cooperate (The Economist, 2018). TPP11 also turns out to be attractive to other countries in the region, whose accession will strengthen CPTPP. Intention to join “11” declares Republic of Korea, Bangladesh, Philippines, India, Cambodia, Colombia, Indonesia, Laos, Sri Lanka and Thailand.

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<sup>5</sup> It’s analysis in: Cordesman (2017).

<sup>6</sup> Weights assigned to threats have been changed: „States are the principal actors on the global stage, but *non-state actors* also threaten the security environment with increasingly sophisticated capabilities. Terrorists, transnational criminal organizations, cyber hackers and other malicious non-state actors have transformed global affairs with increased capabilities of mass disruption” (White House, 2017c).

<sup>7</sup> „China and Russia are now undermining the international order from within the system by exploiting its benefits while simultaneously undercutting its principles and ‘rules of the road’. (Department of Defense, 2018).

<sup>8</sup> General Dunderf – the chairman of the Joint Chiefs of Staff stated „If you look at the health of our alliances in the region ... The evidence reflects anything other than a decline in Pacific power. We have enduring interests here, we have enduring commitment and an enduring presence in the Pacific.” (Dunderf, 2018).

<sup>9</sup> „Mutually beneficial alliances and partnerships are crucial to our strategy, providing a durable, asymmetric strategic advantage that no competitor or rival can match. This approach has served the United States well, in peace and war, for the past 75 years. Our allies and partners came to our aid after the terrorist attacks on 9/11, and have contributed to every major U.S.-led military engagement since. Every day, our allies and partners join us in defending freedom, deterring war, and maintaining the rules which underwrite a free and open international order.” (Department of Defense, 2018).

<sup>10</sup> The pace of ratification is in favour of the presumption that the agreement will enter into force in 2019.

EU economic cooperation in the form of “third wave” RTAs with Republic of Korea<sup>11</sup>, Japan, Singapore (concluded)<sup>12</sup> and with Australia and New Zealand (in the process of negotiations) is a response to economic challenges related to globalization and the challenges of new economic powers (especially China).

In the sphere of security, an attempt was made to fill – potentially – the vacuum created after the withdrawal of American security guarantees. Withdrawal of the US is to be compensated by cooperation, the beginning of which (since May 2017) has been patrolling the Pacific waters by the US, Japan, France and United Kingdom. In addition, the United Kingdom in the face of Brexit shows interest in cooperating with CPTPP (Gregory, 2018). The reactions of European allies to the Japanese proposal to deepen cooperation by going beyond the sphere of economic relations and the institutionalization of ties in the sphere of security and defence policy are clearly positive.

We believe that trans-regional economic, political and defence cooperation between the EU and the Asian countries of the western hemisphere creates the conditions for stopping destabilization and strengthening security in the regional and global dimension. The EU-Japan Agreements are manifestation of such cooperation.

## MATERIAL AND METHODS

The research method is based on the critical review of literature and the analysis of source materials (the texts of the Agreements and official documents). We run a policy analysis. We examine the law as a tool for policy implementation (New International Legal Process). We draw conclusions based on them.

## THE SUBJECT MATTER OF THE EU-JAPAN AGREEMENTS

On February 1, 2019 EPA entered into force – the largest free trade zone in the world started operation on that day. Also on that day, as a result of provisional application of SPA, the largest area of free and safe personal data flows was created in the world. The Parties, with the package of newly created agreements, generate a legal framework of “enhanced political and sectoral cooperation and joint actions on issues of common interest, including on regional and global challenges” (European Commission, 2019a).

Both EPA and SPA are an expression of the Parties’ support for the institutionalization of plurilateral cooperation and against international relations in the form of single and one-dimensional transactions and the pursuit of immediate profits. They are also for free and fair trade, and against protectionism; and for the commitment and the will to implement the values and principles<sup>13</sup> common to societies of both Parties in all spheres – alongside the economy – security, sustainable development, climate protection, consumer protection, labour standards, etc.

The Agreements have created an economic and socio-political framework for new dimension of EU-Japan relations. They have different legal status: – EPA is in force (European

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<sup>11</sup> See more in: Richey, Han&Kim (2019).

<sup>12</sup> See more in: Hoang&Sicurelli (2017).

<sup>13</sup> These include democracy, the rule of law, human rights, good governance and market-based economy.

Commission, 2018a); – SPA is provisionally applied and awaits ratification (European Commission, 2018b)<sup>14</sup>; – IPA is being negotiated<sup>15</sup>. EPA – for the most part – has liberalized trade in goods and services. SPA sets the legal framework for strategic partnership, confirms the community of values and facilitates cooperation against common challenges (Article 1). IPA will regulate legal standards for investment protection and (above all) dispute resolution (probably in a new institutional formula of ISDS).

EPA and IPA are a „new generation” EU agreements, which means that they are comprehensive trade agreements regulating not only trade in goods but also services and providing for not only elimination of customs duties but gradual abolition of all restrictions in international trade within the „Trade for All” Strategy (European Commission, 2016).

The agreement in force, EPA, is a bilateral agreement establishing a free trade area between the EU and Japan<sup>16</sup>. It is so far the largest trade agreement concluded by the EU. EPA is one of the three subsets that make up a set of EU trade agreements, which are: – customs unions; – association agreements, stabilization agreements, (deep and comprehensive) free trade agreements, economic partnership agreements; – partnership and cooperation agreements. EPA can be regarded as a representative of the last category.

As the EU has exclusive competence in areas covered by the agreement, therefore it is not subject to ratification by the Member States. It results from the decision to include in the agreement only the domains falling within the exclusive competence of the EU and not to include, *by contrario*, the issues going beyond this scope, consisting of provisions regarding the broadly understood investment issues. The EU, remembering difficulties and controversies accompanying the conclusion and ratification of CETA, decided at all costs to avoid the conclusion of one large mixed agreement with Japan. The Commission, as part of the division of EU treaty relations with Japan into economic and political, has separated economic relations into trade and investment (in fact, the resolution of investment disputes) ones. This procedure has made – as it seems – easier to create regulations, at the same time giving away the threat of a political dispute and difficulties with ratification of the agreement regulating merits of investment matters (*de facto* ISDS matters, creation of the new ISDS mechanism).

The effect of implementation of EPA is the ongoing liberalization of trade in goods and services. EPA will promote trade through the elimination of tariffs and the reduction of non-tariff barriers, including the regulatory cooperation or harmonisation of law between the parties.

The outcome of negotiations is that both parties agreed to provide almost free bilateral access to their markets. Japan will eventually (after 15 years of entry of the Agreement into force) fully liberalise 97% of its tariff lines (86% immediately at the entry into force)

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<sup>14</sup> SPA parties assume that the Agreement will come into force in 2019. The schedule does not seem to be threatened. The first Joint Committee under the Japan-EU Strategic Partnership Agreement was held on March 25, 2019 in Tokyo (MOFA, 2019).

<sup>15</sup> The lack of declarations on the state of progress on IPA indicates only that the parties keep it in a tightly closed room, in which, however, a consensus was created. The ratification of SPA and IPA will also require a positive decision from the parliaments of the Member States.

<sup>16</sup> Initially, the parties differed in terms of the scope and depth of the Agreement: whether it should be an only free trade or economic partnership agreement. It was decided at the EU-Japan Summit in 2010 that work on both agreements will be conducted in parallel. Eventually, the Commission obtained an extension of the negotiating mandate – the original one was limited to the FTA. Acceleration of negotiations and the final decision to conclude EPA took place in response to changes in the international environment.

and 99% of imports, while the EU will liberalise 99% of its tariff lines (96% at the entry into force) and 100% of imports. On the 3% of tariff lines not fully liberalised, Japan has given significant concessions in terms of tariff rate quotas or tariff reductions.

Apart from elimination of tariffs, the non-tariff measures in relation to manufacturing and agricultural goods are reduced or eliminated, and the common rules for determining the origin of goods, technical barriers to trade, sanitary and phytosanitary measures are being introduced.

Particularly important, from the point of view of implementation of EPA, are extensive, detailed dispositions regulating the determination of the rules of origin. Issues relating to this matter – disputes in case of the absence of regulation, may in fact prevent any agreement regulating trade in goods or introduce significant non-tariff restrictions, or be a source of continuing controversy.

EPA parties confirmed both the fact that technical barriers to trade (TBT) in many cases only serve to protect the market and do not serve the declared purposes, and the will to eliminate the existing TBT and not introduce the new ones. The parties also decided to establish institutional and procedural safeguards against breach of agreement in the future (Article 13).

In the case of liberalization in trade in services, the scope of the agreement is very broad. An important element of EPA – from the point of view of public debate – is the way the public services were regulated. During the preparation for the conclusion of CETA and TTIP, the representatives of extreme positions in public opinion stimulated fears of the alleged forced privatization of public services as a result of concluding agreements. Therefore, it is important that EPA includes a negative regulation explicitly stating what the agreement does not require<sup>17</sup>.

EPA significantly liberalizes movement of people, which is important from the point of view of the EU. Lifting existing restrictions will allow European entities to operate directly on the Japanese market.

The investment issues have been partially regulated by EPA. However, it does not cover investment protection standards and dispute resolution. They are going to be regulated in IPA, which will regulate the investment issues comprehensively, referring and repeating (partially) the relevant EPA standards and it will comprehensively regulate material, as well as procedural and legal issues in the settlement of investment disputes<sup>18</sup>. The separation of investment protection from EPA, in particular the settlement of investment disputes, makes it a non-standard agreement. At the same time, the parties indicated unequivocally that they treat the domain of investment as inseparable from economic relations, as evidenced by its combined treatment with the remaining regulated matters in the Preamble of the Agreement. This proves the tactical nature of the separation of this domain, used for internal use of the EU. However, this *modus operandi* tactic – creation a policy of *fait accompli*, raises doubts as to whether it does not lead to a circumvention of law-democracy.

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<sup>17</sup> „On the question of public services, the EU-Japan Free Trade Agreement, like all other EU free trade agreement, maintains the right of Member States’ authorities to keep public services public and it will not require governments to privatize or deregulate any public service at national or local level. Member States’ authorities retain the right to bring in to the public sector any privately provided services. Europeans will continue to decide for themselves how they want, for example, their healthcare, education and water delivered”. (European Commission, 2017, p. 7).

<sup>18</sup> First of all, the most controversial investor-state disputes but also state-state disputes.

Both EPA and IPA are considered to be (mutual, preferential) trade liberalizing agreements, known as Regional Trade Agreements – RTA. They belong to the “third wave” of regionalism. The beginning of the “third wave” is dated to 1995 and is associated with the conclusion of the Uruguay Round and the creation of the WTO. Conclusion of EPA was actually possible due to the Uruguay Round. Nowadays, each WTO member is also a party to a RTA.

EPA confirms the long-term trend according to which subsequent states or (regional) economic integration organizations conclude RTAs recognizing that they can achieve more by creating a special regime by means of bilateral or plurilateral regimes than under the WTO multilateral regime. In addition, EPA, also in the manner typical for RTAs of “third wave”, covers in its scope of regulation some of the subject areas in relation to which it was not possible to reach agreement in negotiations at the WTO forum.

One of the key characteristics of “third wave” is that RTAs often include bilateral agreements between parties located in different continents. When analyzing EPA and IPA through the prism of entities participating in it, it is simply a classic case of finding partners geographically distant. This is determined by a number of factors, among which it is evident that the stock of partners in the neighbourhood is depleted. An important factor that facilitates the conclusion of RTAs outside the geographical region is the ability to use a model of such agreements which results from a big number of such agreements. RTAs of the “third wave” have *de facto* created a framework agreement only modified to individual needs, which speeds up the conclusion of agreements and reduces costs. RTAs of the “third wave” become a serial product created by parties using the “common platform”, which reduces the costs of creation or use of knowledge.

Another fact proving that EPA and IPA can be regarded as the example of the “third wave” of regionalism is that the parties represent a comparable level of development and economic potential.

One more key feature of “third wave” RTAs is that they cover areas other than only trade in goods. When characterizing EPA through the scope of regulation, it should be noted that it belongs to the PTA (Preferential Trade Agreement) category, classified as WTO+ (after the transitional period customs duties will be eliminated, i.e. the level of cooperation will be increased – in relation to multilateral obligations – under the current WTO mandate) and WTO-X (covering new areas, i.e. going beyond the WTO mandate) (Singh, 2014). EPA provides rules in areas such as sustainable development with an emphasis on environmental protection, corporate social responsibility, labour standards, facilitations for small and medium enterprises, consumer protection as well as regulatory cooperation or harmonisation of law in areas covered by the Agreement.

In spite of the fact that EPA goes beyond the liberalization of trade in goods and services (which is typical for the agreements of “third wave”), it does it unusually, because the broadening of the scope of normative regulation is significantly greater than in the case of comparable agreements. EPA upgrades the typical RTA model – it is the first RTA to form a relationship with the Paris Climate Agreement (PCA), by including obligations of the parties to cooperate – in various forums – in implementation of the PCA. This hard and sharp commitment is important from the perspective of the PCA itself, as it proves that important (and perhaps the main) potential actors of cooperation have decided to sustain and develop it, rejecting the arguments of the opponents and not taking the opportunity

to bury it, which was given by the US decision to withdraw from the PCA. It is also important for other international actors (including states), as it is a signal of the expectations of the superpowers (not just economic ones, which are the EU and Japan).

At the same time, EPA is not a typical RTAs of the “third wave” because it only slightly enlarges and deepens the economic dimension of EU-Japan legal ties. Contrary to other RTAs of this wave, EPA (without the issues regulated by IPA) does not cover the full scope of regulations regarding investments.

The last agreement, provisionally applied SPA, embeds cooperation of parties in the context of the paradigm they represent. A broad catalogue of values and views constituting this paradigm has been articulated in the Preamble. It confirms: “REAFFIRMING their commitment to the common values and principles, in particular, the democracy, human rights and fundamental freedoms”. The statements contained in the Preamble have a clear normative content which determines the binding force of Preamble. The catalogue of challenges indicated in the Preamble is controversial, despite the declaration that it is not exhaustive. “Proliferation of weapons of mass destruction, terrorism, climate change, poverty and infectious diseases, and threats of common interest in the maritime domain, cyberspace and outer space; ... most serious crimes ...” were indicated, while for example aggression and annexation of territories were not<sup>19</sup>.

EPA and IPA are also embedded on a foundation of shared values and principles. The Parties strongly emphasize the values that unite them, making at the same time – which is politically interesting – choice of standards that set this system, namely, recalling the values expressed in the United Nations Charter and the Universal Declaration of Human Rights (and not in the human rights pacts). The proof of the community of values of the Parties is also the announcement of cooperation at the UN forum in the creation of new regulations in the field of safety and environmental protection.

There is a two-way action between SPA and the other two agreements, i.e. EPA and IPA. It is a set of all three agreements that will create a strategic partnership between the parties – the community of values. The Parties use the SPA as a tool to complement the policy of the West and maintain its components negated by the United States. What is new – but known from the EPA – is the appreciation of the Universal Declaration of Human Rights at the expense of concealed pacts. Generally, the SPA confirms and deepens the conviction that the separation of EU-Japan relations between EPA, IPA and SPA is only possible and rational from a procedural perspective.

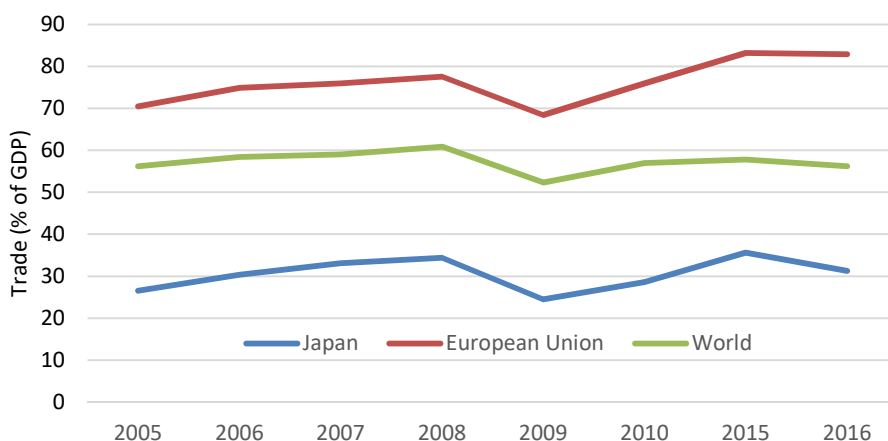
### **THE CHARACTERISTICS OF THE PARTIES OF THE AGREEMENTS**

Both the EU and Japan are developed, industrialised democracies, sharing common values like the rule of law, with strong economic and political links, and closely cooperating with one another in international and multilateral fora such as the UN, the WTO, the G7 and G20 (European Commission, 2018c). Japan is the 3rd richest economy in the world (by GDP) (World Bank, 2019b). Japan and the EU together account for more than a third of the world economy (De Gucht, 2018). Japan is one of the EU’s closest partners and a key ally in the Asia-Pacific region. It is the EU’s 2nd biggest trading partner in Asia after

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<sup>19</sup> See more on SPA: Gilson (2016), Berkofsky (2017).

China. However, it is the EU's only 7th most important trading partner worldwide<sup>20</sup>, while the EU is Japan's 3rd trading partner. So there is an untapped potential in EU-Japan trade relations which was at the core of the decision to launch negotiations for a bilateral trade agreement. EPA, by abolishing tariff and non-tariff barriers to EU's and Japan's markets, opens up new opportunities resulting from expanding markets. The importance of EPA for parties is affected by the share of trade in their GDP. In case of the EU trade accounts for almost 85%, while the world average is 56% (see figure 1). For Japan the corresponding number is much less – 31%<sup>21</sup>.



**Figure 1. Trade openness of Japan, EU-28 and world, 2005-2016**

Source: own elaboration based on: World Bank (2019a).

Fast growth of trade and GDP of both partners can be forecasted as a result of implementing EPA. In 2012, the Commission forecasted that the cumulative economic effect of all (then) negotiated FTAs would exceed 250 billion euro, increasing the EU's GDP by 2% (equivalent to the GDP of Austria or Denmark) (De Gucht, 2018). The simulations made in 2018, based on the actual outcome of EPA negotiations forecast that by 2035 (when EPA is fully implemented) EU's GDP will increase by 34 billion euro more (or extra 0,14%) and Japanese economy will grow by 29 billion euro more (or 0,6%) when compared to the situation with no agreement. This is also accompanied by an increase of EU exports to Japan by about 13 billion euro and of Japanese exports to the EU by about 23 billion euro (European Commission, 2018c).

### THE REASONS OF CONCLUDING THE AGREEMENTS

The EU and Japan are continuing the two-way process of creation of a legal framework for mutual relations and implementation of legal and political standards covered by existing

<sup>20</sup> Japan is 6th extra-EU export partner, and 7th extra-EU import partner (in 2018) (European Commission, 2019b).

<sup>21</sup> This low share in case of Japan is due to the collapse of the Japanese exports after 2008. It was a combined effect of the global downturn in 2008 and a natural disaster – earthquakes in the pacific coast of the Tōhoku region (11.03.2011) and the nuclear power plant disaster in Fukushima.



commitments. It is a long-lasting process with variable dynamics. This process encountered many different barriers, among which public opinion pays particular attention to the US-EU-Japan triangle<sup>22</sup> of interests and interactions as well as potential economic challenges, not always recognizing the importance of cultural differences in the sphere of functioning of both individuals and society.

Awareness of the difficulties associated with cultural differences, however, was not perceived by the EU and Japan as an insurmountable obstacle but as a challenge that can be faced together. This has been demonstrated by the proposals of deregulation<sup>23</sup> of the Japanese economy presented by the Commission, as a way to refloat the economy suffering from the Asian financial crisis. The European response to the Japan's economic problem was not *schadenfreude* when the economic rival suffered the troubles (in politics Japan was – informally – a strategic ally of the EU as part of the western hemisphere). We consider these particular European proposals as the starting point in the calendar of works on the subject matter of the Agreements researched in this paper. The essence of the proposal was the willingness to help Japan in carrying out the institutional transformation, which was to lead to get out of the crisis and to initiate the economic growth thanks to – among others – restoring confidence in the economy. Apart from the content of the proposal, it was important that the parties have mutual confidence in each other and are capable of dialogue in matters falling within the internal sphere of the state (demonstrated by the proposal and positive reaction to it). In bilateral contacts, the parties searched for what is common or for brings them closer to each other, not what differentiates them. This way – with the use of official, semi-official and unofficial contacts – the EU and Japan led to the entry into force (January 1, 2002) of the Mutual Recognition Agreement (MOFA, 2001). The agreement, by limiting non-tariff barriers, facilitated trade in goods.

The political impulse for the EPA negotiations were the arrangements made during the 20th EU-Japan Meeting (May 2011). It took a year to agree on the agenda (until May 2012), and the subsequent months passed on the EU internal procedures. The official start of negotiations was on 25.03.2013, and the first round of negotiations took place in Brussels on 15-19.04.2013. Although the parties declared “toughness” in the negotiations, and even readiness to withdraw from them, the talks were conducted quickly and the will to reach the agreement was evident. Works on the agreement were carried out in the “4 steps” formula: preparing, negotiating, finalising, signing (European Commission, 2012), i.e.: 1) the Commission submitted to the Council an application for the negotiating directives; 2) the Council adopted negotiating directives and indicated the Commissions to conduct negotiations; 3) the Commission negotiated on behalf of the 28 Member States; 4) after obtaining the authorization from the Parties, the agreement was initially signed in the procedure of a co-decision of the Council and Parliament (European Commission, 2018d).

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<sup>22</sup> The tops of this triangle are strategic allies, being at the same time extremely different. The US is (still) the only hyperpower in the strategic dimension (perhaps China will achieve this rank), remaining a national state (see more: Khanna (2013), Dasgupta (2018)). The EU and Japan are – at best – the superpowers, and the beneficiaries of American security guarantees. At the same time, when the world returns to the Hobbesian culture of rivalry, the USA, using the instruments of unilateralism, confronts itself with more and more new players of the “axis of evil”, while the EU and Japan, adhering to Wilsonian values and methods, follow the path of multilateralism (see also: Kagan (2003, 2004, p. 65-87).

<sup>23</sup> The deregulation dialogue between the EU and Japan has developed since its official establishment in 1994 and is continued.

Already after the negotiations were started, it was decided to exclude from the agreement the domain of investment protection and negotiate it separately; it was negotiated by another team led by M. Martin-Prat. This separation creates a new model for the conclusion of EU trade agreements (“free trade agreements architecture”), under which, according to the ECJ ruling of 16.05.2017, the issues falling within the exclusive competence of the EU were separated from the shared competences, where the concluded agreement is a mixed agreement.

### THE IMPORTANCE OF THE AGREEMENTS FOR THE CONTRACTING PARTIES

In the western hemisphere and consequently in the world, the paradigm of international relations stating that the necessary condition for achieving peace and justice – the values declared by the societies and countries of the western hemisphere as desirable in international relations – is “free and fair trade” is being questioned. The author of this paradigm was the USA, and this country, as part of its policy of leadership, worked to implement it.

A multi-element (because it encompasses principles that shape the political- and socio-economic system) regime of western values influenced both internal and external relations. Relations between countries belonging to the “west” can be treated as evidence of a positive verification of The Dell Theory of Conflict Prevention<sup>24</sup>. At the same time, the United States’ potential has grown throughout this period, and the country has eventually become an essential hyperpower. The American leadership also included the role of an intermediary in the transcontinental relations of the allies. Transcontinental political and socio-economic relations of European, Asian and (both) Americas’ countries belonging to the “west” were maintained (predominantly) *via* the USA.

All this structure – including values, norms, institutions and practices – is consistently demolished by President Trump. Under these conditions, a transpacific bridge connecting the EU with Asia is being built. This bridge – potentially, after the end of turbulence in US policy – will allow to create a stable triangle of the states of two oceans (Atlantic and Pacific). The strategic triangle is a desirable response to threats to stability and security in the world. The states of this space can institutionalize the security community, ensuring their nations the sustainable development and protecting the remaining ones from the effects of the safety vacuum.

From the perspective of these threats, it is particularly important to uphold the rules of “free and fair” trade and to institutionalize the community of values between the EU and Asian countries implemented in the form of EU-Japan agreements. We perceive the three agreements as a tool for defending international order against actions or persons threatening it. The agreements not only refer to values, but – potentially – they also strengthen and institutionalize these values.

The EU and Japan have recognized that the cooperation is a source of benefits. Implementation of the Agreements will bring the spill-over effect. The Parties are convinced of the possibility – limited in time – of substituting the role of the US in maintaining the “west” by creating by-passes connecting the allies from the regions of Europe, America (Canada and the countries at the south of Rio Grande del Norte), Asia and the Pacific, maintaining order,

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<sup>24</sup> According to it: „No two countries that are both part of a major global supply chain, like Dell’s, will ever fight a war against each other as long as they are both part of the same global supply chain” (Friedman, 2005, p. 421).

value and paradigm. They see the possibility to meet the challenges of both strategic rivals (China, Russia) and the strategic partner (USA). The EU (and its Member States) and Japan co-create a functional (i.e. without institutions) security community<sup>25</sup>.

In the past the political relations between Europe and Japan, from the perspective of Europe, were directly related to US-Japan relations. Despite the community of values, principles and interests, these relations were always *de facto* maintained by and with the participation of a third party – the USA. For decades, Japan has been a “big mute” in world politics – at the same time being a great payer, a state that stands out in a humanitarian and development assistance. However, both Japanese silence and Japanese action were not perceived by public opinion to an extent proportional to the scale of phenomena. What the public perceived in Europe with regard to Japan was its economic activity. Relatively rapid evolution of the Japanese economy from an imitator to an innovator, from a producer and seller of low-quality cheap products to a competitor in the rivalry for market dominance was arousing – effectively fomented and strengthened by European economic entities – fears of failure in competition with Japan. As a result, Europe erected an economic wall that was supposed to separate (protect) it from Japan<sup>26</sup>, while in the political and security sphere it did not build bridges connecting it with Japan. The economic policy of Japan was a mirror image of this. Contrary to so many and so important factors connecting the EU and Japan, these actors remained for decades at a distance, which was only partly due to the geographical distance.

## CONCLUSIONS

The three Agreements making closer political and economic ties between the UE and Japan open the way to creation of the EU’s security community with “democratic diamonds” in the Asia-Pacific region. The importance of the Agreements is co-decided by:

- endogenous factors, resulting from economic and political potentials of the parties;
- exogenous factors, in the form of external determinants of cooperation. These factors include turbulence in US politics.

We find that the Agreements are a tool for the defence of international order against threats. The political context of the agreements is determined by US policy in relation to regions and problems, which is in contradiction with long-term strategy of the US. This is a source of instability, particularly dangerous for the strategic actions of the rivals of the “west”, challenging the international order. US, rejecting the paradigm of “free and fair trade” and collective self-defence of the free world, put the allies in a safety vacuum and made them unable to face threats. In addition, it happened under Trump’s neo-isolationism policy and under the conditions of undermining US obligations. The Agreements are a tool of protection against the emergence of a safety vacuum. The Agreements additionally activate Japan, which ceases to be a „big mute” in world politics.

Cooperation between Parties proves the spill-over effects. The EPA is especially source of economic and social benefits, but it also creates the unprecedented ties in EU-Asia relations which are comparable with EU-US relations. Entry into force of the EPA is beneficial

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<sup>25</sup> As the Euro-Asian institutional security community was not built.

<sup>26</sup> Analogous to that erected by Japan.

for all parties from the point of view of: direct impact on the economy (bilateral relations); indirect impact, as it strengthens the position of the Parties in cooperation with strategic partners and in global competition; the influence on the power of the Parties.

The Agreements do not create a rigid legal framework for cooperation. It may be subject to both deepening and broadening. We claim that Japan and other countries of the region as well as the EU, when confronted with the threat (above all - the American neo-isolationism), show the ability to independently take up the challenge. This cooperation, leading to the construction of a transpacific bridge, may become – after the return of the US to traditional policy – a pillar of the cooperation of the states of the Two (Atlantic and Pacific) Oceans.

The entry into force of the agreements requires monitoring of their implementation through the prism of their impact on bilateral, regional and global relations. The choice of "unilateralism" by the EU and Japan on the one hand and "multilateralism" by the US on the other creates a unique research opportunity to assess the cost-benefit of both forms.

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# Market and marketing within the concept of functioning and development of cultural heritage sites

Andrzej Szromnik

## ABSTRACT

**Objective:** The article presents the conditions, factors, and stages of development of the market orientation of cultural heritage objects. The author introduced a terminological distinction – the cultural potential of the object and its market potential. The market potential is understood as the ability to generate revenues from commercial activities (products and services).

**Research Design & Methods:** The conceptual nature of the article determined the scope of methods used in diagnosing, analyzing, and synthesizing the phenomena and processes discussed. These were primarily critical literature studies, which usually limited considerations of the market role of cultural heritage objects to the cases of museum institutions and their tourist functions.

**Findings:** Developing and organizing knowledge about the market concept of the functioning of cultural heritage objects, as well as indicating the main directions in the strategic marketing management of these objects. Besides, the paper points out the relationship between the cultural potential and market potential of historic buildings and outlines its significance.

**Contribution & Value Added:** The presented concept of market orientation of cultural heritage objects breaks with the narrow understanding of the market of these objects and its only marginal role in generating development factors. The sustainable development of historic buildings should be focused on a balance between its functional goals (protection and conservation), socio-civilization goals, and economic ones.

**Article type:** research paper  
cultural heritage; heritage marketing; heritage industry; heritage tourism; marketing of museum; market orientation of culture; economic of culture

**Keywords:** tourism; marketing of museum; market orientation of culture; economic of culture

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## INTRODUCTION

In a market economy, every organization, regardless of its founding statute, enters into various relationships with other entities in horizontal or vertical system structures. The first type of structure mainly includes market relations, reflecting the totality of relationships with suppliers of goods and services, on top of relationships with customers: consumers, users, agents, or co-operators. This applies not only to commercial organizations, but also to many non-profit organizations focused on non-financial, socially useful purposes, not involving economic value creation.

Many groups of non-profit entities sector, more often called the civil sector, includes a subgroup of quasi-non-profit organizations, which in addition to broadly understood social goals, successfully pursue parallel or secondary objectives by entering in numerous and varied market relationships characteristic for purchase and sales transactions. Likewise, independently and on their own account, they make and offer their own products. Thus achieved revenues increase the amount of their social power resources necessary for their functioning. This type of institutions includes historic buildings and their complexes, which, due to their importance for the identity of nations and ethnic-regional groups possess valuable, unique and symbolic qualities are referred to as cultural heritage sites.

Cultural heritage sites in general and using some simplification will be referred to herein as historic buildings, historic property or historic building complexes. Although their activities are funded from the budget of the central, departmental, and local government, they supplement their finances with their own revenue streams. This is the result of a creative and rational approach to the overarching and priority social and civilization objectives. It also stems from searching and determining a functional compromise, meaning, a broad understanding of the goals and social mission assigned to cultural heritage sites.

The acceptance of the priority and superiority of social goals, in the practice of cultural heritage sites, does not prevent them from an appropriate orientation towards the efficiency of services and the use of held human, tangible, and intangible resources. It is thanks to an extended operational program, thanks to incorporation of new areas of activity, that additional opportunities open up to improve their economic and financial situation. It all comes down to proper interpretation of mission and strategic objectives in the functioning of cultural heritage sites, and in fact is necessary to reorient their management and other staff.

The aim of this study is to present and clarify the conditions, possibilities and forms of the market operation concept of historic buildings. The category of "market potential" of an object is introduced, confronted and compared with its cultural potential. On this basis, a simple cycle changes model from cultural potential to the market development potential was worked out. The provided block diagram mapping the marketing steps to reorient the object of cultural heritage is proposed as a general model. The creation and the implementation of value exchange (usability, satisfaction) between the object and its customers (stakeholders) is a basis of the marketing management philosophy.

This study presents conceptual and theoretical considerations, explaining a breakthrough moment not only in the functional transformations of historic sites, but also many other institutions of culture. Observing the sector market transformations taking place here

leads to the conclusion that this is a response to the new and wider perception of such places and their role in society as well as economy. The presented generalizations, proposals and conclusions are a voice in the scientific debate about the scope of market relations in culture and in this particular segment thereof: the material, architectural heritage.

### LITERATURE REVIEW

The mainstream considered herein is related to the marketing perspective of cultural heritage, and therefore, its possibilities and the conditions of applying marketing in the implementation of current and prospective objectives of their activities in a particular social, economic, legal and natural environment. The marketing concept of managing that specific cultural resource as the management of an institution with a unique mission in society derives from the area of cultural economics, the economics of cultural goods also known as the economics of cultural heritage. They assume the perception and treatment of historical sites as entities of the contemporary market of goods and services as entities oriented towards a specified range of profit, revenue generation and excess allowing them to limit the costs of their operation to some extent (Barański, 2016; Ilczuk, 2012; Jung, 2011; Kopeć, 2016; Throsby, 2010; Murzyn-Kupisz, 2010; Murzyn-Kupisz, 2016; Towse, 2011).

Pointing to the desirability of market restructuring of cultural heritage, the need to change their organizational and functional concept, and as a result, reorientation of their program offers, is not a new approach. Marketing and appropriate marketing strategies in the business of historic buildings have been discussed by the authors of many scientific publications indicating and specifying details of the marketing way of thinking and acting that would be appropriate to the specific characteristics, position and resources of these entities,. From a chronological perspective, works of Thornburg (1986), Dominquez (1986), Herbert, Prentice, and Thomas (1989) are noteworthy.

In the Polish marketing literature, the first papers devoted to marketing in the cultural sector were authored by the Wrocław authors from the then University of Economics (now the University of Economics), namely, the monographs edited by Knecht, Styś (1990) and Mazurek-Łopacińska (1997). The Wrocław stream also includes a book by Sobocińska (2015). Marketing in relation to the operation and management of cultural institutions was the subject of monographs of many other Polish authors, including Niemczyk (2007), Wróblewski (2012), Łodziany-Grabowska and Wiktor (2014). This group should also include the monographic study of foreign authors (translated into Polish) by Dragicevic-Šečić and Stojković (2010). All the listed authors treated the cultural sector narrowly, along with its subject structure, functional features and potential marketing strategies. Indeed, they focused on cultural institutions such as theaters, operas, cinemas, concert halls, cultural centers and art galleries. The few cases of reference and practical accounts regarded objects of cultural heritage as market wholes, as an integrated concept of cultural chattel and properties with the corresponding special events, the involved artists and designers (Smoleń, 2013). Another point of view was adopted in the monograph by Parowicz, Who considered the marketing of cultural heritage, on the basis of conservation services (Parowicz, 2019).

Sites of cultural heritage – historic buildings, architectural and environmental complexes, and the most valuable historic properties were not previously subject to comprehen-

sive and relevant conceptual considerations or design work discussing their marketing strategies in a systematic and complete manner, together with the relevant instruments and techniques of market stimulation. These objects are usually seen as centers of cultural tourism, and thus their marketing studies analysis focused on tourist services: product concepts, pricing instrument structure, the promotion of these services and the ways of distributing them, and target marketing offers. Tourist point of view in the discussion of marketing is visible in studies: Chhabra (2010), Fullerton, McGettigan, Stephens (2010).

A functional approach, proper for examining the activities of historic buildings from the perspective of the leading narrowly understood function is a hallmark of many monographs in the field of marketing cultural heritage sites. Their authors examine objects such as museums. In this way their market activities boil down to a supply of paid museum services. Without questioning the legitimacy and the need of seeing the museum as a specific “enterprise” or more generally a “market entity” one cannot, however, equal the marketing of cultural heritage sites and museum marketing. This is due to the obvious fact that not every museum is a museum of historic interiors. Many of them are located in modern premises that do not meet the criterion of “historicity”. It is the items displayed there for the public that have the historic character and value. Despite this limitation, some monographs dedicated to the “museum heritage” and services associated with it are noteworthy Kowalczyk (1995), McLean (1997), Simm (2006), and also Matt (2006); Kotler *et al.* (2008); Montemaggi and Severino (2007), French and Runyard (2011), on top of one by Sparr which treats the problems of social responsibility and sustainable functioning of cultural heritage (Starr, 2013).

A wide perspective on “heritage marketing” is offered by the unique monograph by Misiura (2006). On its 280 pages, the author explains and develops a marketing concept of the functioning of the “heritage industry” (heritage industry), discussing, among other issues, the essence of heritage marketing, market segmentation, the marketing mix concept (in relation to the markets of tourist services, and the food and beverage industry), in addition to preparing marketing campaigns. Despite the lack of direct reference to the marketing strategies of cultural heritage sites, Misiura’s work deserves high appreciation and recognition for its leadership in this area in the marketing literature.

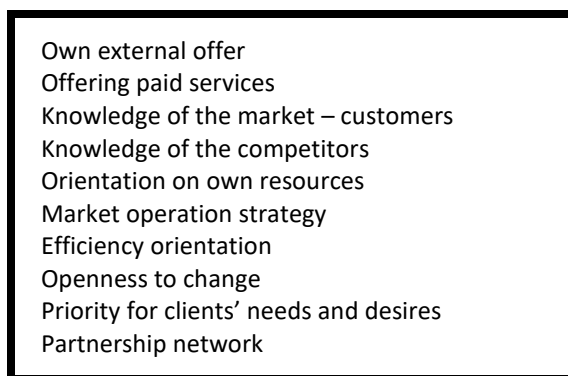
Marketing of cultural heritage in many cases is considered as closely connected with place marketing” known in the Polish literature as urban and regional marketing, or location marketing. This is evidenced not only by the work of Napolitano and De Nisco (2017), but also, and perhaps above all, by the Third. Caribbean International Conference on “Heritage – Tourism and Hospitality” (2014), during which Govers gave an introductory speech on “The Role of Heritage in Place Marketing and Branding.”

In addition to these published texts, the issue of cultural heritage marketing can be found in teaching-oriented projects. “Marketing of Heritage sites” was taught, among others, by Cenderello (2015) in the framework of the European “Lifelong Learning Program” project, which was a HISA (Heritage Interpretation for Senior Audiences) project in Italy. It should also be emphasized that the subject matter has been included in a postgraduate studies project under the name of “Heritage Academy” initiated and successfully implemented in Krakow by the International Cultural Center and the Malopolska School of Public Administration at the Cracow University of Economics for years.

## MATERIAL AND METHODS

### Cultural potential and market potential of an object of cultural heritage

In above deliberations, historic buildings and their eligibility for the special group of historic sites, cultural heritage was considered according to a definition, due to their high qualities and their importance for future generations. Therefore, their artistic, social and civilization-building value was taken into account and evaluated. Such a view and classification of these objects can be called passive qualification, because it omits important operating parameters: functionals, which determine the real potential of cultural heritage to generate income streams market. Examination of a site from the point of view of its condition, value and importance as a “legacy of former generations” (passive perspective) should be replaced by an assessment of its capacities and opportunities to meet current human needs in terms of learning about the past, gaining knowledge of communities forever lost, and their characteristics, everyday life, habits, skills, preferences, aspirations and other activities. The transition from passive description and the treatment of cultural heritage sites to active characterization, stressing the “dormant” possibilities in the historic site requires an introduction of the concept of “cultural potential”. This term refers to a particular site and determines its active cultural, active, possible operating resource for practical use. The existence of a valuable site is one thing, but its ability to meet the constantly changing human needs, wants and expectations which are not always fully known, is another. This means that it might be the case that the site of high cultural value has a limited or even mediocre cultural potential. Qualities and their possession are important, but more so is the social use of the values, and their transformation into a useful resource for development.

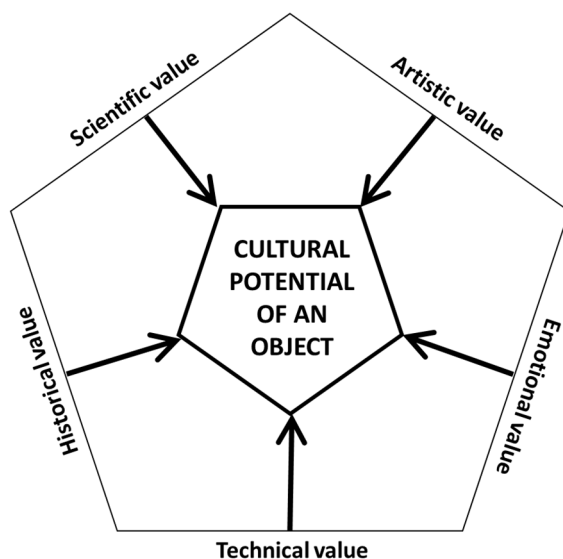


**Figure 1. Historical object on the market (10 functional features)**

Source: own elaboration.

Examination of the potential of a cultural heritage site requires the broadening of the spectrum of the social value assessment. The aforementioned characterized system of three features, that is, artistic value, historical value and emotional value is therefore proposed to be extended by further two criteria of scientific and technological value. In the first case, the importance and usefulness of the site for science, or in fact, for scientific disciplines and the

concrete benefits resulting from this for the scientific cognition, depending on the formulation and claims. The scientific value of a site might be due to its uniqueness, particular nature of its functions, design, technology, materials used or use (Fig. 2).



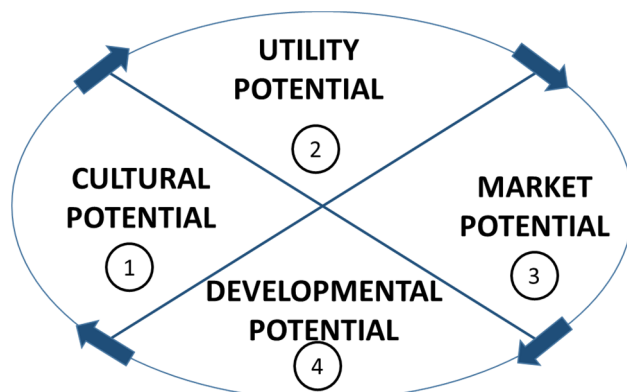
**Figure 2. Cultural potential of a cultural heritage object and its main ingredients**

Source: own elaboration.

An important feature of a cultural heritage site determining its cultural potential is its technological value. It is determined by the condition of the site, the degree of destruction of its elements, the durability and the similarity to the original state. The technical condition may be perfect, corresponding to the original, but also very poor, even completely in ruins. There are, of course, certain relations between the introduced traits, as the technological value affects the historical and artistic ones to some.

The potential of a cultural heritage site in its operational, active interpretation influences another, akin characteristic, namely its potential utility. This, in turn, determines the market potential of the site, understood as the ability to generate the expected market flows: operating income due to marketing of its material resources (movable and immovable goods, objects and human resources, durable and non-durable assets).

Taking into account and ordering all the introduced categories into a logical sequence: cultural potential (initial state), utility potential and market potential, one can determine the final category, that is, the development potential of the institution of a historic building as an independent market entity. Thanks to a high market potential, new development opportunities arise. Increased revenues are the source of purchases, rents, hires of additional service-making factors, which in turn allow the entity to develop, expand and improve its offer profile and to market specific products. In this way, the cycle of changes in the cultural heritage site has been specified, as a cyclic, repetitive mechanism of interconnection between the potential characteristics of a historical site (Fig. 3).



**Figure 3. Development cycle – changes of cultural heritage object**

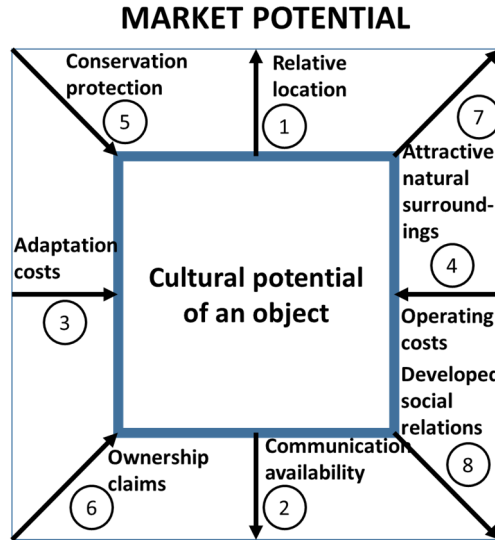
Source: own elaboration.

In the mechanism of the development of cultural heritage, the relationship between cultural potential and market potential has a key importance. It defines the relationship and the corresponding interactions of the two main characteristics of the site. To explain and clarify the signaled cause-and-effect relationship more precisely one needs to identify the most important particular factors that contribute to the enlargement or reduction of the market potential of a historic site with a particular cultural potential. Thus, for each site, eight traits that affect its marketing potential are proposed, wherein a + (plus) indicates a factor contributing to an increase in the capacity, and the - (minus) sign, a respectively negative market potential factor. Therefore, the following stimulants and destimulants of market potential in historical sites have been adopted:

- (+) location relative (to a large city, in a neighborhood, populated areas),
- (+) accessibility by transport,
- (-) costs of adaptation, building repairs,
- (-) operating costs,
- (-) scope of conservation,
- (-) ownership claims (unspecified legal status),
- (+) attractive natural surroundings,
- (+) complex social relations (local, regional, national, international).

Thus compiled list of determinants of the market potential of a historic building is certainly not a closed one. It was deliberately brought down to the principal factors, even if ignoring other factors of organizational, technical, economic (price conditions for making the site available to the public) and marketing nature (Fig. 4).

Two features considered, “culture potential” and “market potential” are in a directly proportional relationship, which is equivalent to the thesis that a high cultural potential of a property and its growth can stimulate the growth of this potential and its further increase. However, it is not always so, which is impacted e.g. by the previously considered factors and circumstances. Selection of cultural potential (one dimension of the matrix) with a market potential (second dimension of the matrix) enables four output solutions: four strategic positions of a historic building (each feature has two states, i.e., a high and low status).



**Figure 4. From cultural potential to market potential**

Source: own elaboration.

**In situation 1:** the position can be described as a “golden goose with the golden eggs” (a combination of: large cultural potential and a large market potential).

**In situation 2:** the position can be called a “golden cage” (a combination of large cultural potential and small market potential).

**In situation 3:** the position can be referred to as a “chance of success” (combination: small cultural potential and large market potential).

**In situation 4:** the position is defined as “harsh reality” (a combination of small cultural potential and small market potential).

The extracted starting strategic positions of a cultural heritage site will help explain the initial conditions for the concept of functioning of sites with different resources and capabilities. The chances of success for sites of with particularly unfavorable combinations of resources are related to the capabilities of status changes from “low” to “high”, in the case of both considered potential indicators. If increasing of cultural potential of a historic site is limited, or in fact impossible, it is the right direction to improve the situation and prospects of growth by increasingly orienting to the market and increasing the market potential of the historic building (Fig. 5).

### **Cultural potential and market potential of an object of cultural heritage**

Market opening of historic buildings which boils down to a conscious, deliberate and systematic, and above all, paid, sharing of resources and opportunities to interested individuals and institutions is associated with the gradual changing of the general concept of the facility’s operation. This change does not imply, however, replacing the social and civilization-making

		<u>MARKET POTENTIAL</u>	
		<u>Large</u>	<u>Small</u>
<u>CULTURAL POTENTIAL</u>	<u>Small</u>	chance for success	<b>GREY REALITY</b>
	<u>Large</u>	<b>CASH COW</b>	<b>Golden cage</b>

**Figure 5. Cultural potential vs. market potential of cultural heritage objects  
– table of strategic positions**

Source: own elaboration.

concept with the concept of a commercial orientation. This would be tantamount to a revolutionary change of a complete change of the goals and ways of achieving them, organizational, material, and also mental changes for the entire staff.

The new orientation – towards the market – should complement the main one, always leading orientation towards society and civilization. It was this direction, after all, that defines and clarifies the meaning of the protection and preservation of tangible and intangible heritage of past generations for the future. A gradual and moderate, properly balanced marketing of heritage sites, its scope, forms and the specific conditions should, as it is assumed, support and strengthen the culture-making mission of heritage sites.

Market-oriented functional changes should be recommended as gradual, evolutionary changes, at every assessment of broadly defined results and expenditures, without bringing this relationship only to a simple economic calculation. In practice, this means the preparation and implementation of experimental activities, activities performed “on trial”, allowing for an analysis and evaluation only, to make the necessary adjustments as a new (paid) offer for the stakeholders.

The whole of the market changes, which in this place can be called marketing changes, can be organized in chronological order with the appropriate separation of six states. These states reflect the effects of widening and deepening the market profile of a cultural heritage site, i.e., the effects of the adoption of marketing as a site management concept (Cf. Fig. 6).

As an initial state of an aspiring market reorienting entity, an “orientation towards legal resources” has been adopted. It corresponds to a set of record-ordering actions, as a result of which the possible resources will be identified and adopted, primarily for formal reasons, and their marketization to use the market offers proposals for potential



clients. The preliminary activities explicitly limit the possible, due to conservation, technical and organizational reasons, whether the site is made available as a whole, or only separated parts of it, or groups of historic items found there (e.g. furnishing, exhibitions, special collections, etc.). The analysis, evaluation and simulations conducted under this stage may eliminate or limit the scope of the market use of the historic building, bringing it to a margin of all activities implemented.



**Figure 6. Six phases of market orientation development of a cultural heritage object**

Source: own elaboration.

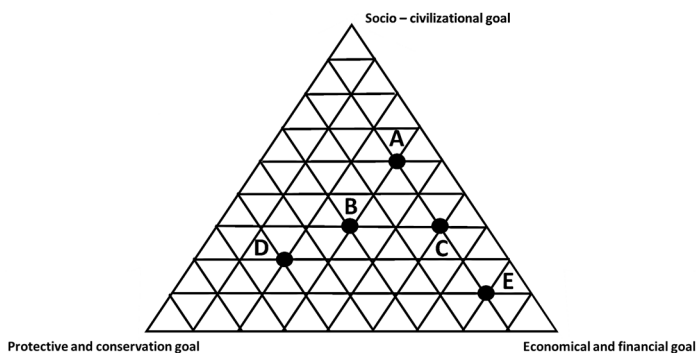
The logical order of market-oriented changes lead to isolating a second, also preparatory step, which was appropriately named “documentary and display orientation”. It involves the development of documentation and information on resources intended for commercial use, and as a result, the creation of historical information resources as an important component of the prospective exhibitions, which is a crucial component in building the attractiveness of the market offer. Exposition preparation of periodic or permanent display is the primary direction and a form of sharing historic buildings. The proper market offer comes down to viewing exhibits and interiors in combination with learning about their characteristics, functions, users and makers. The information provided, together with feelings, sensations and evaluations created, make up the market advantages of the exhibition offer.

Preparation of the historic building and the corresponding expositions to explore does not guarantee a good frequency of visits and a resulting financial profit. To a large extent, this depends on the rightly directed, convincing and attractive promotion of the project. This boils down to a broad, mass and accurate communication of the project to potential stakeholders based on the involvement of popular media. This stage in the gradual commercialization of cultural heritage, according to its essence, is referred to as the promotional orientation stage. Dissemination of information to promote a historical site, encouraging visiting, renting or leasing or even purchasing part or all of it is expressed by an appropriate marketing approach to the management of this particular cultural resource in a market economy.

Active, professional market communication does not mean the right marketing orientation of the historic building yet. This stage is reached when the main reference point for the market projects is the potential customer whose needs and desires in terms of knowledge and experiences, sensations and feelings are the basis of the arrangement of the exhibition, the individual rooms and the equipment of the historic building.

The marketing concept of cultural heritage site functioning mainly corresponds to mental changes in the staff, including managers and owners of the site. They should recognize and accept the priority of the market – the subordination of the functional concept of the entity to the requirements and expectations of customers and the whole market environment. A proper, full marketing orientation of historical sites as institutional monuments of culture is already the fifth stage of their respective evolutionary change is constituted by the requirements of the modern times, which is a condition for the smooth functioning and development based largely on the use and sharing of resources.

The last stage in the procedure of the proposed evolutionary reorientation of cultural heritage sites is a phase of changes, the last stage called “sustainable marketing orientation”. It is an operating concept of historical sites which implies a purposeful compromise, balancing the main operational objectives, which is the appropriate relationship of the three groups of purposes: to protect and conserve, to build civilization and society, and to maintain economic and financial balance. Such a balance expresses a correct, appropriate, adequate to the possibilities and expectations of society, distribution of activities and priorities. Any deviation from the point (area) signifying the equality of the objectives indicates a preferential dominance of one of these objectives and the associated degradation of the others. In this way, one can identify and group cultural heritage sites, which are clearly oriented towards one of the following functional purposes and those whose activities are close to a compromise in their aspirations, preferences and priorities (Fig. 7).



**Figure 7. Triangle of balanced functioning of a cultural heritage object  
(Presentation of different variants of the distribution of goals)**

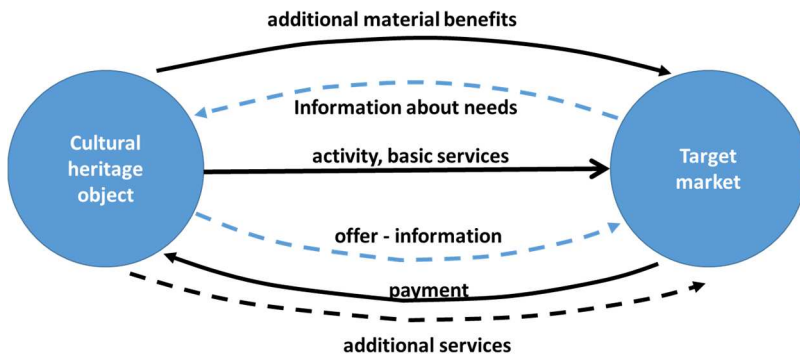
Source: own elaboration.

The market orientation of cultural heritage sites corresponds to the concept of a consistent focus on the present and future needs and desires of customers (visitors, participants, tenants, and future owners). It is its characteristic idea for the product offer along with the conditions and terms of making it available to the public. Marketing and consequent orientation is also a way of market-oriented thinking of all the staff, accepting the customers and

financial revenues flowing from their use as an important source of development throughout the organization. The marketing orientation does not dictate the historic sites what to do in an administrative top-down way. It is the result of searching for new development opportunities, and possibilities to gain important additional benefits in its immediate environment.

### Value replacement as the basis of the marketing concept of cultural heritage sites

The marketing way of thinking and entrepreneurial action can be considered in relation to both the business of human activity, and projects of a social nature as opposed to profit-oriented. It assumes, however, the existence of relationships of exchange between entities (partners, collaborators, parties in court cases) where each offers a package of marketing values of major importance for each recipient. Bi-directional flow of value streams (benefits, utility, satisfaction) connects the sender of value with its recipient. This means that each entity receives a significant value, but also passes some value to the partner of exchange (Fig.8).



**Figure 8. Basic diagram of marketing value exchange**

Source: own elaboration.

Media marketing value carriers being exchanged are usually tangible goods and cash. Increasingly, however, exchanged values arise from the provision of services to one's partner, information provided to them and ideas submitted. The most important matter is the right choice of benefits available for a fee, partially payable or free, or such values, goods, services, ideas, information or places that will be highly appreciated by the customers and will bring them maximum satisfaction. Organization's marketing staff track record priorities, expectations and opinions of market operators, in order to propose the most effective and satisfying combinations of the offered securities on their basis.

Sites of cultural heritage that adopt and adapt a system of marketing thinking and acting shape a set of values appropriate for their own resources, capabilities and operational objectives to be provided to their partners. They are primarily guided by the needs and wants of their partners previously identified. The basic scheme of marketing value exchange involving historic buildings does not, therefore, differ from the general scheme of market exchange.

The main value created and made available through the heritage site to its customers and partners is clear and is connected with the activity, utility, and the main services provided by it. The value of the basic service, that is, enabling the customer to get acquainted

with the presented exhibition, is complemented by accompanying additional services of a different nature, together with a set of historical information. The scope of services results from prior identification of the needs, expectations and interests of the main groups of recipients. Thus, the supplied set of intellectual (sensations, impressions, experiences), but also utilitarian values (transportation, food, accommodation, entertainment, training) is exchanged for money (payment) and a number of emotional values such as appreciation, praise, feedback and own assessment.

The bi-directional flow of value (benefits) as a condition of the marketing approach, allows them to balance them and compare their importance to consumers. Thanks to this specific balance, a subjectively understood resulting surplus or deficit in the values for each of the parties to the transaction of exchange is made possible. In the first case (excess value), it generates corresponding satisfaction and its intensity, and in the second case, absence thereof and the accompanying disappointment and disapproval of the value exchange.

To sum up this part of the considerations, it should be stressed that the marketing approach to the operation and development of cultural heritage is based on precise and systematic recognition, creation and anticipation of the needs and desires of customers and partners, which results in acquiring information used for the shaping of market-accepted proposals regarding the main products.

## CONCLUSIONS

The market orientation of cultural heritage sites, due to external and internal conditions of this process, is a complex and multi-faceted endeavor, and it is also difficult from the organizational, legal and mental point of view. The particular importance of this process and its crucial meaning for the organization had already been indicated in the pioneering work of Murzyn-Kupisz (2010).

Treating a cultural heritage site as a modern market entity generates the question of how to “marketize” the functioning of such organizations. It is a question on the nature and purpose of changing the philosophy of historic buildings. Defining a universal program of investigation to fully open up the entities in question to the market is not easy, it is not possible to be implemented directly and does not guarantee the final success of the respective project. Therefore, intending to even outline and to indicate some degree of generalization of a functional program of restructuring, a model is introduced that is recommendable to many other entities introducing a formula for the market as a strategic priority.

The model program of cultural heritage market reorientation provides for the implementation of several pilot and preparatory projects, namely:

- a precondition to convince the entire management team of the cultural heritage site to the idea of the market restructuring through discussion, simulation, and providing examples of opportunities and threats in the “new reality”,
- transformation program expanding functional priorities that should be disseminated among all groups of employees in the form of direct messages, websites and synthetic written communication,
- a detailed scenario for the development of the necessary changes, modifications and operational corrections, as well as their implementation in practice; establishment of a

- Restructuring Team composed of representatives of all groups of employees. The proposed measures should have a directional executive power across the facility,
- preparation and completion of economic, managerial and marketing training program is recommended in terms of content tailored to the needs and qualifications of employees,
  - in a situation of educational and management resources' shortage, it is recommended to seek advice of external specialists – experts and consultants in the field of culture, economics, and marketing services.

The implementation of the signalled preparatory program will facilitate the mental and operational change of options to the functioning of the cultural heritage site. In the end, a lack of contradiction between the “traditional” concept and the market concept of the activities will be revealed. The process of market restructuring of historic buildings can be implemented gradually, taking into account the identified stages of development based on the criterion of minimizing the social and financial costs of the necessary reforms.

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## An attempt to estimate the competency gap in the IT sector

Paweł Lula, Renata Oczkowska, Sylwia Wiśniewska, Katarzyna Wójcik

### ABSTRACT

**Objective:** The aim of this article is to determine whether there is a gap between the demand for competencies of graduates of the computer science major and their supply.

**Research Design & Methods:** Identification of the key set of competencies required by employers from job applicants and estimation of the competency gap in the IT sector was conducted using the method of exploratory analysis of job offers for positions related to the administration of IT systems.

**Findings:** The results of the preliminary research shown that proposed method can be used for estimation of competency gap however it requires more experiments.

**Contribution & Value Added:** Proposition of new method for competency gap calculation based on exploratory analysis of data available in the Internet.

**Article type:** research paper

**Keywords:** competency; competency gap; labour market; IT sector; Latent Dirichlet Analysis

**JEL codes:** J40, C51, C63

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### INTRODUCTION

The functioning of contemporary companies and their demand for labour change very rapidly. The technological growth and innovations lead to changes in the structure of the demand for labour, but also to modification of the labour market segmentation. The dynamics of changes in the labour market is increasingly faster, which also means a quick outdateding of the existing competencies and a growing demand for new competencies, especially in the IT sector. Changes in the content and methods of work cause consequences in the knowledge and ability to use new technologies or new IT tools. An imbalance appears in the demand and supply of competencies, which, in turn, affects the functioning of enterprises. In general, employers are looking for employees with competencies different from



those possessed by job-seekers. This phenomenon, constituting the difference between the required and the possessed competencies, is called the competency gap.

Many reasons for the occurrence of the competency gap may be indicated. The most frequent reason for its presence lays in the intersectoral structural transformations. Emerging branches often lack qualified employees capable of meeting the requirements of positions related to modern technologies. The competency gap may be deepened by the teaching programmes being ill-adjusted to the needs of the labour market. Therefore, it is particularly important for the enterprise competitiveness to monitor the demand for competencies, including identification of trends regarding changes of the demand for labour. It thus becomes significant to create possibilities of identifying the employer demand for professional qualifications and the supply of qualifications earned in various forms of learning and certification of the achieved results of learning. This would allow employers to acquire competent employees and would facilitate evaluation or modification of the results of learning and education earned in various educational institutions, above all, at universities, focused on the needs of the labour market. This approach would also help people who are studying plan their personal and professional development.

The aim of this article is to determine whether there is a gap between the demand for competencies of graduates of the computer science major and their supply. The presence of the competency gap would indicate that this market is imperfect and requires the application of appropriate corrective mechanisms enabling reduction in these disproportions, resulting in larger satisfaction of the employers' demand for competencies of graduates of IT majors at universities.

Identification of the key set of competencies required by employers from job applicants in the IT sector was conducted using the method of exploratory analysis of job offers for positions related to the administration of IT systems, posted on the website pracuj.pl. On the other hand, the self-evaluation of competencies of IT students was conducted in the form of an on-line survey among 200 students of the applied computer science major of the Cracow University of Economics.

On the basis of the research, it can be determined whether and to what extent studies at the applied computer science major of the CUE correspond to the expectations of the labour market, and thus whether and to what extent a competency gap exists.

## LITERATURE REVIEW

### The essence of competencies

The literature on the subject does not agree as to what the professional competencies of employees are. The multiplicity of approaches results mainly from the fact that the issue of competencies is analysed by specialists representing different scientific disciplines: management, psychology and sociology.

The issue of competencies began to be considered in literature at the turn of the 1960s and 1970s, which was reflected in publications of White and McClelland. However, deeper interest in competencies was initiated in the 1980s by Boyatzis, who defined competencies as the capacity of a given person to display behaviours compliant with the requirements of the job position specified by the organizational environment parameters, which, in turn,

yields the desired results (Armstrong, 2011). Furthermore, Boyatzis (2008) brings attention to the fact that demonstration of competencies at work is affected by the organization of a given business activity, namely: culture, structure, maturity of a given organization, and the position of the contractor. The environment is also significant, which is determined by the following aspects: economic, political, social, religious, and environmental. However, in any case the level of competencies, but also the possibility to their development, is determined by: proficiency and professional experience, recognized knowledge, procedural knowledge, functional knowledge, as well as the possession of certain cognitive skills, ensuring independent execution of a new task, and related to memory, identification of dependencies, deduction. In the opinion of Boyatzis, competencies may differ, and the level of their diversity is shaped by: cognitive competencies, such as system thinking and recognized behaviour patterns, competencies related to emotional intelligence, including self-awareness, self-control, as well as social competencies, including social awareness and management of mutual relations through empathy and teamwork. The notion of competencies in the concept of Boyatzis thus assumes taking into consideration the sphere of work motivation, work variability, its performance – especially the possibility to raise or adapt to increasingly higher standards of work performance.

A similar employee-oriented approach is presented by Thierry, Sauret & Monod (1994). They define competencies as the employee's capacity to take action leading to achievement of the intended goal under specific conditions, using specific means. Furthermore, competencies are the entire knowledge, skills, experience, attitudes, and the employee's readiness to act under particular conditions, and thus also the ability to adapt to these changing conditions.

One of the supporters of competencies being considered from the perspective of the employee is also Armstrong (2000), who believes that competencies are the potential contributing to the achievement of specific results. Remaining in this trend, Oleksyn (2006) defines employee competencies broadly as their interests, abilities and dispositions, education and knowledge, experience and practical skills, internal motivation, attitudes and behaviours important in professional work, health and psychophysical condition, formal equipment with the right to act on behalf of a given organization, professed values and ethical principles. A broad definition of competencies is also presented by Poczowski (2007), who brings attention to the fact that it is a notion wider than qualifications, covering all permanent features of a human, creating a causal relation with the achieved high or outstanding work results, which can be measured. It is worth referring to the notion of qualifications, which cover the employee's capacity to perform a specific job confirmed by relevant documents, e.g. diplomas, school certificates or documented work experience. However, the possession of qualifications does not determine the possession of competencies. At the same time, it is necessary to have personality traits, attitudes and behaviours that enable proper use of the available knowledge and skills in effective implementation of entrusted tasks.

In the previously presented perspectives, competencies are examined from the point of view of the employee, which is the so-called American approach. However, competencies are also connected with the position. This, in turn, is the so-called British concept, which was created for the needs of the National Vocational Qualifications project (NVQs), which was aimed at better adjustment of educational programmes to the needs of the

labour market, focuses on the job position and on defining tasks and effects from the point of view of the requirements set by particular workplaces for their contractors.

In the Polish reality, this approach is represented by Król (2006), who understands competencies as dispositions with regard to knowledge, skills and attitudes, ensuring implementation of professional tasks at an effective or outstanding level, according to standards specified by the organization for a given job. Currently, the more widespread depiction of competencies in theory and practice of management is the American one. This approach provides significantly more possibilities of adapting to changing situations. Flexibility in adapting to situations, to a specific and variable organizational context, results in the fact that competencies are revealed while performing a specific work. Professional work usually requires continuous updating of competencies. This applies particularly to functioning in conditions of uncertainty and variability, which is associated with choices and making decisions, and not only with workmanship, where activities have the nature of an algorithm.

In connection with the presented discussion, it can be stated that, in the Polish reality, competencies are examined both in relation to the employee and the job position. However, it should be emphasized that many authors consider both concepts at the same time. The mixed approach is represented, among others, by Filipowicz (2004). In his opinion, competencies are predispositions with regard to knowledge, skills and attitudes, allowing for pursuance of professional objectives at an appropriate level. A similar perspective is presented by Rostkowski, who acknowledges that competencies are knowledge, skills, predispositions, and attitudes of employees, which – when used during work – help implement the organization's strategy (Juchnowicz ed., 2014).

To sum up the above considerations, it can be stated that the mixed concept of understanding competencies from the perspective of the employee and the job position is complete and correct. Undoubtedly, the conformity of competencies with the job requirements is a necessary condition for an effective process of improvement in the quality of work (Nowakowska *et al.*, 2011). Furthermore, the definitions of competencies presented in the subject literature are not homogeneous, they are interpreted differently and consist of various components. However, it may be considered that the key elements of competencies are knowledge, skills and attitudes, which – when used during work – help implement the organization's strategy.

### **Typology of competencies**

The subject literature includes various typologies of competencies. Among the most popular is the classification of Katz (1974). He distinguishes the following types of competencies:

- technical – they are necessary for current work and for solving technical problems, making decisions requiring specialist knowledge, as well as support for employees with small professional experience. They cover, among others: specialist knowledge within a given field, knowledge concerning methods of work, production processes, procedures and technologies, as well as the ability to use technical equipment,
- social – they constitute proper behaviour in relations with other people (superiors, subordinates, co-workers or clients). This category includes such competencies as: building of relations, sensitivity, communication skills, understanding of motivations and attitudes of other people, as well as diplomatic approach. These competencies determine the social position of a given person and the strength with which he/she influences others,

- conceptual – they refer to analysis and synthesis of data, formulation of conclusions, capacity to make the right decisions and creative problem-solving, as well as prediction of changes, noticing of opportunities or creation of action plans. They are of key importance in the process of defining and implementing strategies in particular areas of operations.

Furthermore, Katz assigned the aforementioned types of competencies to particular levels of management. Therefore, he indicated dependencies between the employee's position in the organization and the competency categories necessary for effective work on the given organizational hierarchy level. According to this author, for people starting their management career, the most important elements are predispositions in the area of social and technical competencies. Such persons should have competencies within their field, should be able to win people over and affect their work. Along with the development of the career to the level of middle-level managerial staff, social competencies gain importance and technical competencies lose importance. At this level, it is very important to build teams, exert influence and motivate to reliable work. Knowledge of technical aspects of work performed by subordinates is less important. The middle level of management is also where the need for using conceptual competencies appears, which are necessary for planning, solving complex and unique problems, as well as for decision-making in a situation of uncertainty. On the other hand, in the case of the highest level of management, conceptual competencies are of critical importance for the success of the conducted activities. However, technical competencies completely lose their importance. Management staff at the highest level is responsible for creation and implementation of the operation strategy and, when necessary, benefits from the aid of advisors.

A complex typology of competencies is suggested by Delamare Le Deist & Winterton (2005), who – under an original model of competencies – divided them into:

- cognitive – related to openness, curiosity, the ability to learn, understand and memorize. High level of these competencies is possessed by people who are not susceptible to the influence of others. They are crucial in childhood and youth, although curiosity and passion for learning can be the human domain through his/her entire life,
- functional – are necessary for effective work in a given profession and on a given position,
- social – involve interpersonal relations and are expressed in the ease in establishing and maintaining contacts, ability to balance different views and interests, solve conflicts and cooperate, e.g. as part of implementation of common goals,
- meta-competencies – on the one hand, they concern the ability to reflect and learn, while on the other hand, the ability to cope in conditions of uncertainty, which is presently gaining importance.

Another classification of competencies, prepared by Filipowicz (2014), refers to the division of competencies in the perspective of Katz and Delamare Le Deist & Winterton. This author distinguishes four basic categories of competencies:

- social – determining the quality performed tasks associated with contacts with people (e.g. commercial contacts). The level of these competencies determines the effectiveness of communication, cooperation and influencing other people. Sample social competencies include, among others: communication skills, teamwork, building of relations, sharing of knowledge and experience,

- personal – related to performance of tasks by the employee, and their level affects the quality of the performed tasks. They also determine the adequacy in actions and the speed of their performance. Personal competencies include, among others: innovativeness, entrepreneurship, flexibility, own work organisation, self-management during a period of time, problem-solving, and stress management,
- managerial – involve human resource management, both with soft areas of management, work organisation, as well as with strategic aspects of management. The effectiveness of management of the organisation's employees is determined by the level of these competencies. Exemplary personal competencies include, among others: analytic thinking, strategic thinking, motivating, delegation of tasks, team-building,
- professional (specialist, technical) – concern specialist tasks set for particular groups of positions. They are often connected with specific scopes of knowledge or skills. The level of these competencies is reflected in the effectiveness of implementation of tasks typical of a given profession, position or performed function. Examples of personal competencies include: process management, project management, professional knowledge, the ability to use modern information technologies.

A different typology of competencies is presented by Juchnowicz (2014). In her opinion, the types of competencies most often distinguished in the subject literature include:

- transferable – affecting the effectiveness of actions in various professional situations. They enable full use of the qualification potential and professional experience of a given person. Transferability of these competencies means the possibility of their “transfer” and successful application in a different (new) professional or personal situation,
- specific – covering a given scope of knowledge, skills, experience, abilities necessary for performance of tasks on a given position and in a given profession. They have a narrow scope and are rich in terms of content. They include complex specialist skills, based on higher education or rich professional experience, necessary for performing complicated work.

The ambiguity when defining the notion of competencies determines the diversity of competency categories. The subject literature contains many classifications of competencies, prepared on the basis of various criteria. The most widely indicated competencies include: professional, non-professional, soft, hard, personal, social, objective, and subjective (table 1).

To sum up the above discussion, it can be stated that the typology of competencies presented in the subject literature are not homogeneous. The classification of competencies including social, personal, managerial and professional will be used as the basis of analysis in the research.

### **Competency gap and its estimation**

The functioning of contemporary companies and their demand for labour change very rapidly. Technological growth and innovations lead to changes in the structure of demand for labour, but also to modification of the segmentation on the labour market. The dynamics of changes in the labour market become faster and faster, which also means quick outdating of the existing competences and growing demand for new competences. An imbalance appears in the demand and supply of competences, which, in turn, affects the operation of enterprises. In general, employers are looking for employees with competences differing

**Table 1. Characteristics of different types of competencies**

Item	Types of competencies	Characteristics
1	Professional	They enable undertaking work in a given profession, as well as promotion and professional success. They enable performance of professional duties as required by a given position.
	Non-professional	They constitute the basis for professional competencies. They are also useful in activities unrelated to professional work. They include, among others: immunity to stress, establishing contacts, responsibility.
2	Soft	They are universal for most jobs and mainly concern self-management and relations with the environment (including other people). They include, among others: teamwork, communication skills, managing emotions, entrepreneurship, assertiveness.
	Hard	They allow for practicing a given profession and performing tasks on a given position. They cover specialist knowledge and skills typical of the specific specialization.
3	Personal	They characterize the person and demonstrate his/her uniqueness. They cover, among others, knowledge, skills, abilities, habits, attitudes, tastes, temper, adaptability. They enable performance of activities from various scopes, contributing to achievement of professional and personal objectives.
	Social	They are shaped and expressed in social interactions. They determine the nature of the relations of a given person with other people. They concern creation of good interpersonal relations.
4	Objective	An internally consistent system of predispositions and properties that enables an effective and ethical performance of duties, regardless of who performs them. They determine the standards for particular competencies for the needs of professions, specializations, job positions, roles performed in the organization. They are helpful in maintaining objectivity in the recruitment process and the assessment of employees.
	Subjective	Competencies actually possessed by a given person, which can be diagnosed as a result of an individual assessment. They consist of physical and mental features, possessed knowledge and skills, abilities, interests, principles, adopted attitudes and styles of action, which are used and developed within professional activity. The subjective aspect of competencies results from their dependence on the specific nature of a person, who uses them throughout the performance of tasks.

Source: prepared by the authors on the basis of: (Jeruszka, 2016; Baron-Puda, 2008).

from those owned by the people looking for jobs. This phenomenon, meaning the difference between required and possessed competences, is called the competence gap (Oczkowska, Wiśniewska & Lula 2017).

In Poland competency gap estimation analysis is done within the Study of Human Capital (pl. *Bilans Kapitału Ludzkiego*) research project which is one of the biggest research projects oriented to demand and supply of competences on labour market in Europe. In this type of research mainly surveys addressed to employers and employees are used. Also job offers are a very important source of information about employers

expectations. In Study of Human Capital in Poland the evaluation of candidates competences was done in a way of a self-assessment of certain competences level of unemployed and jobseekers (Czarnik et. al. 2019).

## MATERIAL AND METHODS

### The formula for competency gap estimation

The estimation of competency gap was the main goal of the research. It was assumed that the measure of the competency gap should reflect the diversity between employers' expectations towards candidates and competencies possessed by candidates. Using the classification presented in table 1 the competency gap can be considered as the difference between objective competencies representing job requirements necessary to obtain certain position and subjective competencies representing candidates characteristics. The process of competency gap evaluation was composed of the following steps:

1. Identification of the list of the key competencies:

$$\mathbf{C} = [C_1, C_2, \dots, C_N] \quad (1)$$

2. Evaluation of the employers' expectations towards candidate competencies ( $\mathbf{C}^E$  – expected competencies). They were defined as a distribution of the employers' expectations over key competencies:

$$\mathbf{C}^E = [p_E(C_1), p_E(C_2), \dots, p_E(C_N)] \quad (2)$$

where:  $p_E(C_i)$  can be interpreted as the probability of the occurrence of the  $C_i$  competency in the employers' expectations. For elements of the  $\mathbf{C}^E$  vector it is guaranteed that:  $\sum_{i=1}^N p_E(C_i) = 1$ . Value of  $p_E(C_i)$  can be treated as a measure of the importance of the  $C_i$  competency for employers.

3. Evaluation of competencies possessed by candidates ( $\mathbf{C}^P$  – possessed competencies) which can be defined as:

$$\mathbf{C}^P = [p_P(C_1), p_P(C_2), \dots, p_P(C_N)] \quad (3)$$

The  $\mathbf{C}^P$  describes the distribution of the candidates' evaluation of their own competencies over the key competencies. For  $p_P(C_i)$  also we have:  $\sum_{i=1}^N p_P(C_i) = 1$ .

4. Calculation of the competency gap ( $cg$ ) as a value of the average Kullback-Leibler divergence between  $\mathbf{C}^E$  and  $\mathbf{C}^P$  distributions:

$$cg = \frac{KL(\mathbf{C}^E, \mathbf{C}^P) + KL(\mathbf{C}^P, \mathbf{C}^E)}{2} \quad (4)$$

where  $KL(f^1, f^2)$  is a measure of the Kullback-Leibler divergence between distributions given by  $f^1$  and  $f^2$ .

The formula (4) shows that the evaluation of competency gap should be preceded by the estimation of  $\mathbf{C}^E$  and  $\mathbf{C}^P$  distributions.

### The evaluation of the competencies expected by employers

The evaluation of competencies expected by employers was realized by the analysis of job offers published by employers in *pracuj.pl* web site (one of the most popular Polish portal with job offers). The contents of offers published at the portal allowed to identify key competen-

cies expected by employers and to estimate their importance (represented by the  $C^E$  distribution). For solving these two tasks the Latent Dirichlet Allocation method was used (Blei, Ng & Jordan, 2003). During the analysis the following sequence of steps was performed:

1. Offers retrieval from the *pracuj.pl* portal.

This task was realized with the aid of the *rvest* package (Wickham, 2016), available in the *R* system. Offers retrieved from the portal had a form of HTML documents. In our research we used offers from the section "IT – Administration".

2. Identification of offer sections containing competency description.

This part of an offer had the form of a list of employer's expectations towards a potential candidate. It has been assumed that every item taken from employer expectation lists is related to one desirable competency. For further analysis every list item derived from offer descriptions was processed as a separate document.

3. The use of the *Latent Dirichlet Allocation (LDA)* algorithm on the corpus containing documents items retrieved from lists of employer expectations.

The *LDA* algorithm allows to identify topics represented in the corpus of documents. Every *LDA* topic is defined as a probability distribution over words (terms) occurring in the whole corpus.

To present crucial elements of the *LDA* algorithm we have a corpus  $\mathbf{D}$  with  $LD$  documents:

$$\mathbf{D} = [d_1 \quad \dots \quad d_{LD}]^T \quad (5)$$

and we can assume that the dictionary  $\mathbf{V}$  is available (vector of all words in a corpus):

$$\mathbf{V} = [v_1 \quad \dots \quad v_{LV}]^T \quad (6)$$

The use of the *LDA* algorithm allows to identify a set  $\mathbf{T}$  of  $LT$  topics:

$$\mathbf{T} = [t_1 \quad \dots \quad t_{LT}]^T \quad (7)$$

which are present in documents from the corpus  $\mathbf{D}$ .

Every topic is defined by a probability distribution over words taken from the dictionary  $\mathbf{V}$ . The matrix  $\Phi$  defines all topics represented in the corpus  $\mathbf{D}$ :

$$\Phi = \begin{bmatrix} \phi_{1,1} & \dots & \phi_{1,LV} \\ \dots & \dots & \dots \\ \phi_{LT,1} & \dots & \phi_{LT,LV} \end{bmatrix} \quad (8)$$

Values  $\phi_{i,j}$  represents the probability of occurrence on the  $j$ -th word in the  $i$ -th topic. Whereas the matrix  $\Theta$  informs about the contribution of every topic to every document:

$$\Theta = \begin{bmatrix} \theta_{1,1} & \dots & \theta_{1,LT} \\ \dots & \dots & \dots \\ \theta_{LD,1} & \dots & \theta_{LD,LT} \end{bmatrix} \quad (9)$$

Elements  $\theta_{i,j}$  indicate the probability of occurrence of  $j$ -th topic in the  $i$ -th document.

The process of the *LDA* model creation incorporates the estimation of  $\Phi$  and  $\Theta$  matrices with the help of available set of documents (represented by the corpus  $\mathbf{D}$ ). During the research presented in the paper, this process was performed with the help of the *topicmodels* package (Grün & Hornik, 2011) available for the *R* system.

4. Evaluation of the *LDA* topic importance in a given job offer.



Assumptions related to the form of the corpus (which was not defined as a set of job offers but as a set of list items describing employers' expectations) caused that matrix  $\Theta$  describes the contribution of *LDA* topics not in offers, but in list items. Therefore it is necessary to aggregate topics' importance over job offers. The schema of required calculation was presented in Table 1.

**Table 2. Evaluation of LDA topics' importance for a given job offer**

Job offer	List items related to a given job offer	Topic 1	...	Topic <i>LT</i>
<i>k</i>	$d_1$	$\theta_{1,1}$	...	$\theta_{1,LT}$
	$d_2$	$\theta_{2,1}$	...	$\theta_{2,LT}$
	$d_3$	$\theta_{3,1}$	...	$\theta_{3,LT}$
	...	...	...	...
	$d_n$	$\theta_{n,1}$	...	$\theta_{n,LT}$
$O_k$	$\pi_{k,1} = \max_i(\theta_{i,1})$	...	$\pi_{k,LT} = \max_i(\theta_{i,LT})$	

Source: own study.

It was assumed that the importance of the *j*-th *LDA* topic in the *k*-th job offer is represented by a maximum value taken from  $\theta_{i,j}$  where *i* represents all list items occurring in the *k*-th offer.

#### 5. Evaluation of the *LDA* topic importance in the whole set of offers.

Having values  $\pi_{k,j}$  describing the contribution of the *j*-th topic in the *k*-th offer it was possible to estimate the importance of every *LDA* topic in the whole set of all job offers. The schema of calculation is presented in the Table 2.

**Table 3. Evaluation of LDA topics' importance for the set of all job offers**

Job offer	Topic 1	...	Topic <i>LT</i>
1	$\pi_{1,1}$	...	$\pi_{1,LT}$
2	$\pi_{2,1}$	...	$\pi_{2,LT}$
...	...	...	...
<i>K</i>	$\pi_{K,1}$	...	$\pi_{K,LT}$
The set of all job offers	$\omega_1 = \frac{\sum_{k=1}^K \pi_{k,1}}{\sum_{t=1}^{LT} \omega_t}$	...	$\omega_{LT} = \frac{\sum_{k=1}^K \pi_{k,LT}}{\sum_{t=1}^{LT} \omega_t}$

Source: own study.

The importance of the *j*-th *LDA* topic in the whole set of offers is expressed by a  $\omega_j$  value. The formula used for its calculation guarantees that the sum of all value  $\omega_i$  is equal one. It allows to interpret obtained values as the distribution of the offer content over a set of *LDA* topics.

#### 6. Identification of key competencies and evaluation of their importance.

It is worth to underline that topics discovered by the *LDA* algorithm may not represent key competencies required by employers. Very often more than one *LDA* topic can be treated as a component of the same competency (for example more than one *LDA* topic can be related to one key competency understood as "competency in computer system security" or "competency in IT project management").

First, for every *LDA* topic, the interpretation was identified. This process was based on the analysis of words with the highest probability of occurrence in the definition of a given topic. Next *LDA* topics were grouped to form key competencies. Topics related to the same competency were included into the same cluster representing one competency. Taking into account the fact that job offers were prepared in Polish or in English language, the *LDA* algorithm discovered topics with the same meaning, but based on words taken from these two different languages. Such topics also were merged into the same groups. The expert knowledge related to the *IT* sphere was used as the basis for the key competency discovery process. As it was mentioned identified competencies were classified into social, personal, managerial and professional groups.

The analysis presented above allowed to discover  $N$  key competencies defined in the formula (1).

The  $q$ -th key competency can be treated as a subset of the  $T$  set.

$$C_q = \{t_1, t_2, \dots, t_Q\} \subseteq T \quad (10)$$

where  $t_j$  represents *LDA* topic used as component of the  $C_q$  competency.

For two key competencies  $C_q$  i  $C_r$  we have:

$$C_q \cap C_r = \emptyset \quad (11)$$

The importance for employers of the  $C_q$  competency can be defined as:

$$I^E(C_q) = \sum_s \omega_s \quad (12)$$

where  $s$  indicates *LDA* topics included in the definition of the  $C_q$  competency.

The vector  $[I^E(C_1), I^E(C_2), \dots, I^E(C_N)]$  is normalized and can be used as an assessment of the employers' expectations towards candidate competencies (represented by the  $C^E$  distribution):

$$C^E = [I^E(C_1), I^E(C_2), \dots, I^E(C_N)] \quad (13)$$

and plays the crucial role in the process of evaluation of competency gap.

### The evaluation of the competencies possessed by potential employees

The assessment of the competencies possessed by potential employees was performed with the use of a questionnaire in which every key competency was evaluated on 5-point Likert scale. In the survey key competencies identified with the use of the *LDA* method were used. For every competency respondents evaluated two aspects:

- respondent's evaluation of the competency importance for potential candidates on the job market,
- possession of a given competency by a respondent.

In the presenting study a self-evaluation approach was used for the competency evaluation. But we are convinced that the same method of analysis can be used when candidates' competencies are estimated in different way (for example by the use of survey among experts). The use of the Likert scale for competency assessment is the only requirement which must be fulfilled.

The following procedure was used:

1. Evaluation of competencies made by respondents with the use of the 5-point Likert scale. Taking into account that the number of key competencies is  $N$ , for every respondent a vector of grades was defined:

$$\mathbf{e}_s = [e_{s,1}, e_{s,2}, \dots, e_{s,N}] \quad (14)$$

where  $e_{s,q}$  is an evaluation of the  $q$ -th competency made by the  $s$ -th respondent. All  $e_{s,q}$  values were expressed on the 5-points Likert scale.

2. Creation of individual preference matrices showing comparative evaluation of key competencies performed by every respondent. The individual preference matrix created for the  $s$ -th respondent had a form:

$$P_s = \begin{bmatrix} p_{1,1}^s & \dots & p_{1,N}^s \\ \dots & \dots & \dots \\ p_{N,1}^s & \dots & p_{N,N}^s \end{bmatrix} \quad (15)$$

where  $p_{q,r}^s$  is a measure of preferences between  $C_q$  and  $C_r$  competencies expressed on the Saaty scale (Saaty, 2008). To calculate the  $p_{q,r}^s$  element of the preference matrix values  $e_{s,q}$  and  $e_{s,r}$  were used:

$$p_{q,r}^s = \begin{cases} \frac{9}{5} \times \frac{e_{s,q}}{e_{s,r}} & \text{if } e_{s,q} > e_{s,r} \\ 1 & \text{if } e_{s,q} = e_{s,r} \\ \frac{1}{\frac{9}{5} \times \frac{e_{s,r}}{e_{s,q}}} & \text{if } e_{s,q} < e_{s,r} \end{cases} \quad (16)$$

3. Creation of the aggregated preference matrix. Presented above individual preference matrices were calculated for every respondent. In the current step of the analysis these matrices were used for the creation of the aggregated preference matrix  $\mathbf{P}$  which had a form:

$$\mathbf{P} = \begin{bmatrix} p_{1,1} & \dots & p_{1,N} \\ \dots & \dots & \dots \\ p_{N,1} & \dots & p_{N,N} \end{bmatrix} \quad (17)$$

The aggregation process was performed with the use of the geometric mean formula:

$$p_{q,r} = \left( \prod_{s=1}^{LS} p_{q,r}^s \right)^{\frac{1}{LS}} \quad (18)$$

where  $LS$  is equal to the number of all respondents.

4. Assessment of the competency importance with the use of the aggregated preference matrix. The matrix  $\mathbf{P}$  calculated in the previous step was used as a starting point for calculation of weights expressing key competency importance. Weights were calculated as a normalized eigenvector corresponding to the highest eigenvalue of the  $\mathbf{P}$  matrix:

$$I^P(C_q) = \frac{\varepsilon_q}{\sum_{i=1}^N \varepsilon_i} \quad (19)$$

where  $\varepsilon_q$  indicates the  $q$ -th element of the eigenvector of the  $\mathbf{P}$  matrix corresponding to the highest eigenvalue. Values  $I^P(C_q)$  were used as the evaluation of competencies possessed by candidates. They can be treated as elements of the  $\mathbf{C}^P$  vector:

$$\mathbf{C}^P = [I^P(C_1), I^P(C_2), \dots, I^P(C_N)] \quad (20)$$

Values defined in formulas (13) and (20) allow do calculate the competency gap with the use of the formula (4).

### Introduction of the data sources

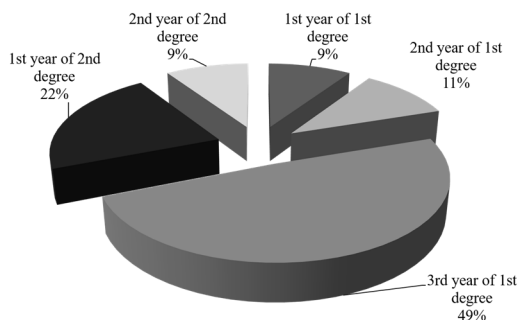
Key competencies and their importance for employers were identified by the analysis of 1618 job offers retrieved from the portal *pracuj.pl* (section: *IT Administration*). The list of the key competences is shown in the Table 3

**Table 3. Key competencies identified by the analysis of job offers published in the *pracuj.pl***

Competency ID	Competency description
C <sub>01</sub>	Information systems administration
C <sub>02</sub>	Project Management
C <sub>03</sub>	Computer systems security
C <sub>04</sub>	Programming
C <sub>05</sub>	Information Systems Design
C <sub>06</sub>	Customer support systems
C <sub>07</sub>	Commitment, analytical thinking, ability to work in a team, ability to work under a time pressure
C <sub>08</sub>	Knowledge of the English language
C <sub>09</sub>	Data Analyst
C <sub>10</sub>	Databases
C <sub>11</sub>	University degree in IT
C <sub>12</sub>	Office software

Source: own study.

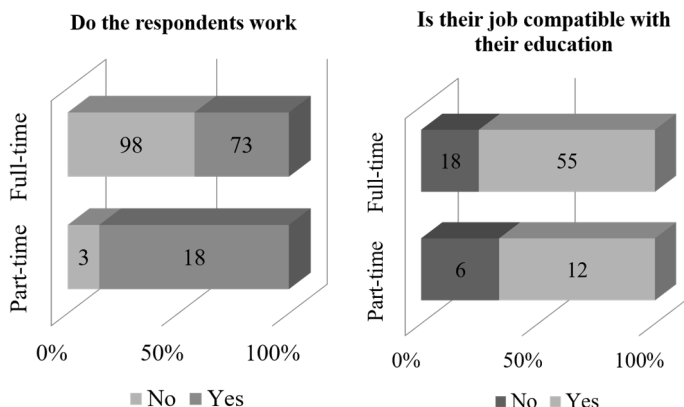
The competencies of students were analyzed by the use of the self-assessment questionnaire filled by 192 students of the “Applied Informatics” program at Cracow University of Economics. Almost 50% of respondents were 3rd year 1st degree students and over 20% were 1st year 2nd degree students (Figure 2.). These is the time when most of the IT students in Poland seek for their first job or at least first job in IT.



**Figure 1. Characteristics of respondents – year and degree of study**

Source: own elaboration.

Most of respondents (about 90%) were full-time students. Most of the part-time and over a half of the full-time students are already working and most of employed ones has job compatible with their education (Figure 3.).



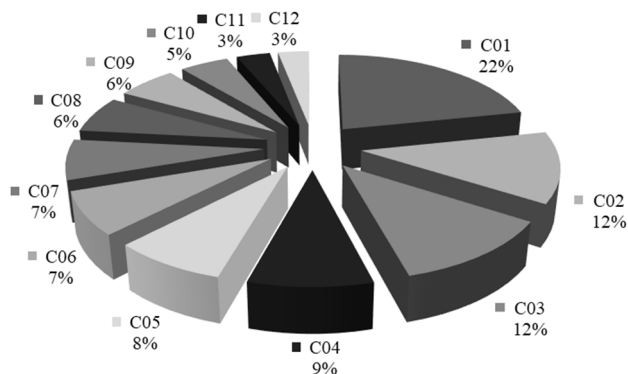
**Figure 2. Characteristics of respondents – employment status by form of study**

Source: own elaboration.

In questionnaire every respondent was asked to evaluate the competency importance for potential candidates and the degree in which he/she possess a given competency. These two aspects were analyzed separately. Students were asked to evaluate only competences presented in Table 3 identified as the most important for employers in “IT Administration” field.

## RESEARCH RESULTS

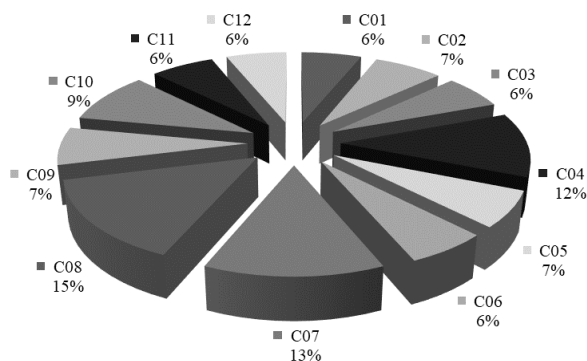
The method proposed in the previous section of the paper was used for the evaluation of the competency gap between employers’ expectations in the “IT Administration” field and competencies possessed by students of the “Applied Informatics” study program at the Cracow University of Economics. Figure 1 presents the importance of key competencies identified by the analysis of job offers published in the pracuj.pl portal which was the first phase of research.



**Figure 3. The importance of key competencies identified by the analysis of job offers published in the pracuj.pl portal**

Source: own elaboration.

In second stage of research the answers to questionnaire were analyzed. First the analyses of competency importance made by respondents were studied. The results are presented in the Figure 4.

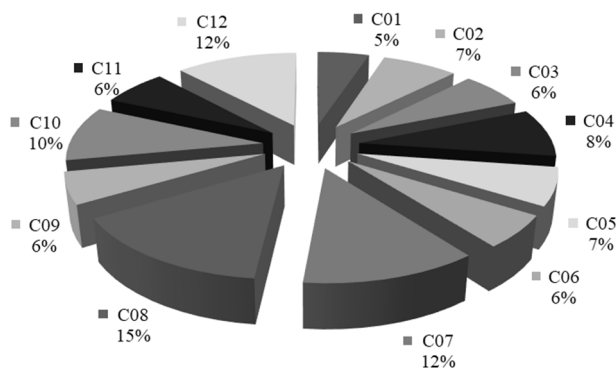


**Figure 4. The evaluation of key competency importance calculated on the basis of students' opinions**

Source: own elaboration.

The competency gap between employers' expectations and students' opinions about competency importance calculated as an average Kullback-Leibler divergence was equal to 0,2302. This measure can be treated as a pseudo distance between two distributions (it is not a distance because it does not satisfy the triangular inequality) which always belongs to the range  $[0, +\infty]$ .

In the survey respondents also were asked to evaluate their own competencies (in the scope represented by key competencies). The results are shown in the Figure 5.

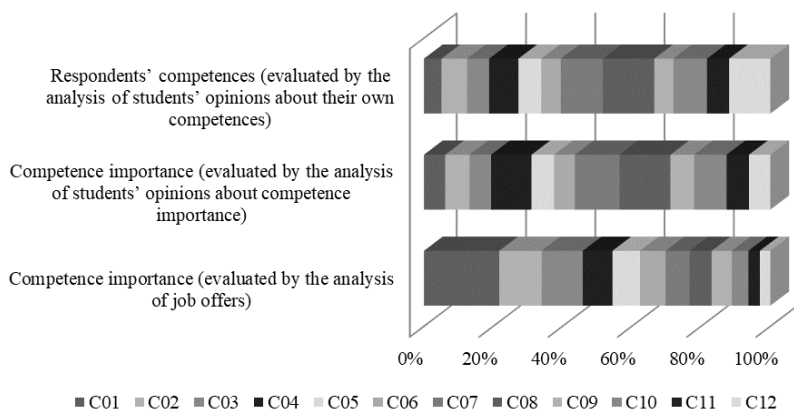


**Figure 5. The evaluation of respondents' competencies calculated on the basis of students' opinions**

Source: own elaboration.

The competency gap between employers' expectations and students' opinions about their own competencies in the scope covered by key competencies is equal to 0,2928. Also the gap between students' evaluation of competencies importance and students' evaluation of

their own competencies was calculated. It was equal to 0,027. The results of the analysis show that students opinions about their own competencies are very close to their opinions about ideal competencies for candidates looking for a job in the IT sector. Unfortunately, students evaluations are rather far from expectations of employers expectations expressed in job offers (Figure 6).



**Figure 6. Comparison of different evaluations of the key competencies**

Source: own elaboration.

## CONCLUSIONS

The results of the preliminary research shown that proposed method can be used for estimation of competency gap however it requires more experiments. The respondents of the questionnaire were Applied Informatics students at Cracow University of Economics who are entering the job market. It is necessary to repeat experiment on wider range of students e.g. from different universities located not only in Cracow. Also it is worth considering to use of the method for different fields of studies and different job offers sections.

To evaluate the correctness of obtained results authors are planning to invite recruiters and HR departments employees to determine what is real competencies demand and what is their opinion about competencies of candidates applying for job in their institutions.

Separate task that is planned is comparison of job requirements and students competencies with study programs to evaluate how well study programs prepare graduates for entering the job market.

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## Competitiveness of innovation-driven economies: Insights from selected European countries

Maria Urbaniec

### ABSTRACT

**Objective:** The aim of this paper is to analyse the role of innovation in competitiveness development and to identify the most competitive European economies. From the perspective of contemporary challenges, the following research question will be considered: How innovations determine development of the most competitive European economies?

**Research Design & Methods:** Besides employing critical literature analysis, the research methods based on quantitative synthesis will also be used. Interpretations are developed through an in-depth comprehensive review of different studies and secondary data analysis.

**Findings:** The results provide valuable insights into how innovations determine development of the most competitive European economies. Measuring competitiveness relies on taking into account both supply-side and demand-side indicators. Based on the GCI both the demand-side as well as the supply-side innovation indicators were identified.

**Contribution & Value Added:** The novelty of the study consists, on the one hand, in developing the conceptual framework for innovative competitiveness that contributes to the shaping of socioeconomic transitions and, on the other hand, in determining the innovation-driven factors of the most competitive European countries.

**Article type:** research paper

**Keywords:** competition; competitiveness; innovation; innovation-driven economies; innovative competitiveness; Global Competitiveness Index

**JEL codes:** O10, O30, O52

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## INTRODUCTION

The shaping of economic policy conditions is the subject of research in various economic approaches. Dominated by Anglo-Saxon economists for over a century, the discussion on economic policy is reflected in classical liberalism, neoclassical theory, as well as Keynesianism. One of the elements influencing the shaping of socioeconomic development is market competition. Competition is perceived as a factor determining not only socioeconomic order at the macroeconomic level, but also the microeconomic developments fostering entrepreneurship and economic activity (De Soto, 2008). This stimulates the innovative actions of enterprises, resulting from adaptation processes to the changing conditions of socioeconomic development (Atkinson, 2013; Urbaniec, 2018).

The article aims to analyze the role of innovation in competitiveness development and to identify the most competitive European economies. This paper provides, on the one hand, theoretical insights into how innovations determine competitiveness development and, on the other hand, it examines innovation-driven factors influencing the most competitive European economies. Aside from employing critical literature analysis, conventional research methods of quantitative synthesis have also been used. Interpretations are developed through an in-depth comprehensive review of different studies and secondary data analysis.

Given the research topic, first, the role of market competition and competitiveness will be presented. In the next step, an attempt will be made to outline the concept of innovative competitiveness from the viewpoint of enterprises that are not only considered as significant entities of the national economy, but also key participants of the market process. After that, the influence of innovation-driven factors on the competitiveness of selected European economies based on the Global Competitiveness Index (GCI) will be analyzed. Finally, the discussion of the research results and conclusion will be presented.

## LITERATURE REVIEW

### **The role of competition and competitiveness in socioeconomic development**

The phenomenon of competition occurs in many areas of everyday life: social, political, economic, cultural, etc. It forms the basis for the functioning and development of the market economy. Competition is related to both the entire economy and the entities operating in it. According to many economists, it is the main method by which basic problems facing modern man can be solved. Market competition is seen as a procedure for discovering what is available to individuals, but unavailable to the public at large (von Hayek, 2002). Due to the fact that competition is inextricably linked to market processes, it is subject to constant changes dependent on various factors contributing to its development or limitations (Listra, 2015). Among the essential determinants (Porter & Rivkin, 2012), the following can be listed:

- the integration of countries and economies around the world, into economically competing groups,
- the globalisation of economic processes,
- the liberalisation of the administrative policy of states,
- the creation of new “carriers” of competitiveness, e.g. the new perception of knowledge as a source of information and competitive advantage.

Competition encourages firms to produce high-quality goods and services at the lowest possible price. The ability of firms to adjust is a measure of their efficiency as well as their competitiveness (UNCTAD, 2009). Therefore, competition is perceived as a key driver of competitiveness (Stiglitz, 2002). The review of the literature shows several concepts and theories of competitiveness. On the one hand there is a nation's competitiveness from the macroeconomic perspective, and on the other hand the firm competitiveness (microeconomic level). The OECD (1996, p. 62) defines competitiveness as "the ability of companies, industries, regions, nations or supranational regions to generate, while being and remaining exposed to international competition, relatively high factor income and factor employment levels on a sustainable basis". The World Economic Forum (WEF, 2017, p. 11) determines competitiveness as "the set of institutions, policies, and factors that determine the level of productivity of an economy, which in turn sets the level of prosperity that the economy can achieve".

Competitiveness can be affected by many others factors, which have been of interest to economists for over two centuries, commencing with the seminal work by Adam Smith (1776). Recent empirical research has been referred mostly to the determinants of firm's competitiveness (Siudek & Zawajska, 2014), probably due to the fact that firms (and not individual nations) compete on international markets, as also claimed by Porter (1990). Generally, it can be stated that success or the lack thereof, in the process of socioeconomic development, is determined by what is taking place in enterprises. In the current era of globalisation, enterprises endeavour to constantly search for and create ventures enabling them to cope with the dynamically developing and complex environment (Porter, 1990). In addition, they also seek to achieve such a systemic reconstruction and change in their structure that would allow them to acquire new features and take actions necessary for their transformations and expansions. Enterprises, as part of the economic and political order, are subject to constant changes resulting from dynamic socioeconomic conditions. Therefore, the functioning of the enterprise is the basis of the economic process and a central element of the entire subjective structure of the economy. The key distinguishing feature of enterprises is the fact that they contribute to creating the largest portion of the national income, and the rationality and effectiveness of their management depends on the standard of living of the entire society (Steckel, 1995). Based on the literature analysis, it can be presumed that the competitiveness is a chief determinant conducive to the socioeconomic development.

### **Conceptual framework of the innovative competitiveness**

The essence of competitiveness is an innovative activity. J.A. Schumpeter emphasised that, owing to market-driven competitiveness and the introduction of constantly "new, often revolutionary" combinations of production factors by "new pioneers", the market economy may develop dynamically (Schumpeter, 2008). This is accompanied not so much by stability and balance, but rather imbalance and instability (Schumpeter, 1934).

The process strictly connected with the essence of the market mechanism, which manifests itself in various forms of competitiveness, enabling an improvement of the economy development in both quantitative and qualitative terms, is termed "creative destruction". It is reflected in Schumpeter's concept of the entrepreneur (routine breaker), whose motivation to implement innovations results not only from planned profits, but also from internal encouragement to take actions (Diamond, 2006; Reinert & Reinert, 2012; Vivarelli,

2013; Block, Fisch & van Praag, 2017). The process of “creative destruction” therefore includes two aspects. Firstly, “creative destruction”, through innovation, selects enterprises in terms of their skills. Secondly, it defines the size of the innovative activity of rival companies. Schumpeter’s “creative destruction” process illustrates that the innovative advantage is considered to be the chief source of economic growth and development. The ability to achieve this type of advantage is a result of intensifying the creation of innovations by gaining a monopolistic market position. According to Schumpeter, those large enterprises and monopolies dominating in the market are more likely to be innovative, whose technological advantage results chiefly from the internal potential of the enterprise, e.g. research and development activities (Schumpeter, 2008). Thus, “creative destruction” is a process that is beneficial in terms of dynamics and efficiency of the development processes, which is reflected in the modernisation of the economy, gaining technological advantages and such changes in structure that demonstrate the growing level of innovation.

In the current era of economic processes, the nature and intensity of various innovative ventures that adapt the behaviour of enterprises to the requirements of the market economy and the state, structure, complexity and dynamics of their surroundings, are decisive for the development of each enterprise (Urbaniec & Gerstlberger, 2011). Innovations can be considered in terms of subject and process. In terms of subject matter, the Schumpeter’s definition of innovation include (Schumpeter, 1934):

- introduction of a new product (or modification of a pre-existing one),
- introduction of a new production method,
- new outlet where a certain branch has not yet been represented,
- obtaining of new sources of raw materials or semi-finished products, without paying attention of whether the source already exists or is completely new,
- changes in market organisation.

In terms of process, innovation includes the primary economic realisation of the invention underlying it, i.e. implementation into the economy. According to what is referred to as “Schumpeter’s triad”, technical changes are divided into: 1) invention, 2) innovation, 3) imitation. Invention requires the expenditure of certain inputs (technology-input), owing to which it is transformed into a technical product in the form of product and process innovation (technology-output), and then disseminated into the enterprise, branch, economy or the world (diffusion). The invention measurement is the sum of R&D expenditures, while the measurement of the final effect is based on the number of licenses or know-how (Schumpeter, 1939). Process innovation has been the subject of broad discussion since Schumpeter’s time. One of the aspects of the innovation process is its division into (Mowery & Rosenberg, 1979; Edler & Yeow, 2016):

- a supply-side model, based on the neoclassical growth theory (close to the Schumpeterian concept), pointing to the need to implement research and development (R&D) processes that are innovative in nature,
- a demand-side model, resulting from the post-Keynesian economy assumptions, according to which the most important mechanism for enterprises is the realisation of market needs. Innovations are treated as a response to new economic opportunities to maximise company profit.

Each enterprise has its own methods of achieving the effects of innovations that may result from both supply-side and demand-side factors. In addition, the innovative process is matched to the market and its participants operating in a given period. The effect of the changes is a new company structure resulting from lower production costs and benefits from new technologies, as well as a new general economic order related to the creation of a new market. Both the supply-side and demand-side factors drive innovation significantly, but their role in influencing the types and outcome of the innovation process can be different (Miles & Rigby, 2013).

In the report by the Business Innovation Observatory (European Union, 2013), it was indicated that technologies enabling new business and production model trends already exist. Therefore, increasing efficiency and utilising potential is not dependent on additional R&D support (supply-side innovation policy). An obstacle in the use of new production processes and business models can rather be seen in the scepticism and conservatism of potential customers. This requires more demand-side policy. Edler and Georghiou (2007, p. 952) define the demand-side innovation policies as “a set of public measures to increase the demand for innovations, to improve the conditions for the uptake of innovations, or to improve the articulation of demand in order to spur innovations and the diffusion of innovations”. In line with this, there is a need for demand-side innovation policies in order to scale up new model trends, and thus competitiveness and socioeconomic benefits. The future impact of more demand-side policy efforts will generate greater growth and competitiveness for companies driving new trends.

It should be added that the creation of new economic opportunities or new technological solutions is the result of dynamic, innovative competitiveness. Innovative competitiveness leads to the greater utility of future products and their improved use, owing to which both the low-cost (low-tech) and more expensive (more innovative) market can be created. It can be assumed that innovative competitiveness is dependent on both demand-side and supply-side innovation factors.

The concept of innovative competitiveness can be defined as a cumulative phenomenon of innovation and competitiveness. It indicates the directions of innovation policy and businesses development, taking into account qualitative changes and potential to create new market solutions, in terms of technology, organisation or marketing. Given the conceptual framework, the innovative competitiveness is shaped by both demand-side and supply-side innovation factors. The supply-side factors result from: R&D grants, tax credits (mostly for R&D), incubator services, soft loans, competition awards and prize-money, public procurement of innovation schemes, networking events (European Union, 2013). Moreover, the demand-side innovation factors are pertinent to: regulation (use of regulation, standardisation), direct or indirect financial support for the purchase of innovations, public procurement of innovation, various types of training, and awareness mechanisms to improve the shaping of conducive regulatory framework conditions (Edler, Georghiou, Blind & Uyarra, 2012). The combination of both the demand-side and the supply-side determinants is conducive to development of innovative competitiveness. This is necessary to achieve a dynamic path of innovation due to the growing complexity and variability of their macro-, meso- and micro-environment, as well as increasing market competition.

## MATERIAL AND METHODS

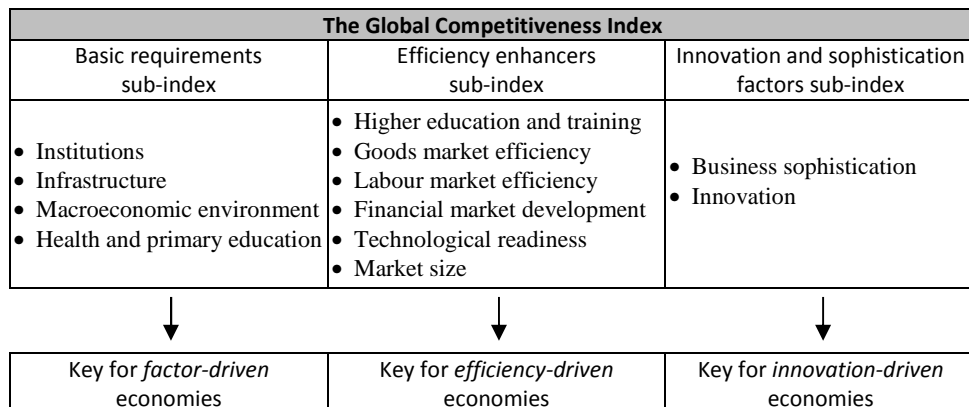
The article aims to identify the most competitive European economies and to analyse the role of innovation in their competitiveness development. The key question arising from this research objective is how innovations determine development of the most competitive European economies. This article also attempts to determine innovation-driven factors influencing the competitiveness of these countries.

The study was conducted by using of different research methods. Aside from employing critical analysis, conventional research methods of deduction, reduction and synthesis were additionally applied. Interpretations were developed through an in-depth comprehensive review of different studies. The research analysis is based on secondary data. For selection and evaluating secondary data a set of criteria were used, e.g.: methodology, accuracy, date of data collection, purpose of data collection, data content (Crowther & Lancaster, 2008).

According to this criteria, secondary data from a survey conducted by the World Economic Forum (WEF) within the Global Competitiveness Index (GCI) were selected. The GCI includes a wide array of determinants of a country's productivity, and reflects the complexity of the socioeconomic development process at both the macro- and microeconomic levels. The methodological approach employed by the GCI reflects a normative approach focused on stimulating discussion about political priorities, and supporting research in this area. The 2017 edition of the GCI Survey captured, in total, the views of 12,775 business executives from various sectors of activity: agriculture, manufacturing industry, non-manufacturing industry (mining and quarrying, electricity, gas and water supply, construction), and services, gathered in 137 countries. Given the selected European countries in this study, the 2017 surveys were carried out among 446 respondents (Switzerland – 52 respondents, the Netherlands – 78 respondents, Germany – 112 respondents, Sweden – 71 respondents, the United Kingdom – 83 respondents, and Finland – 50 respondents) (WEF, 2017).

Competitiveness is measured using different indicators contained in 12 components such as: institutions, infrastructure, macroeconomic environment, health and primary education, higher education and training, goods market efficiency, labour market efficiency, financial market development, technological readiness, market size, business sophistication, and innovation, that provide a comprehensive picture of the competitiveness landscape (Figure 1). These components are grouped into three sub-indexes: basic requirements, efficiency enhancers, and innovation and sophistication factors, which refer to different stages of economic development, i.e. factor-driven, efficiency-driven, as well as innovation-driven economies. All countries, chosen for the further analysis, were classified into innovation-driven economies.

Given the research objective of the article, in particular the innovation component is important for further analysis. The research methodology included three stages. In the first step, attention was drawn to indicate ten of the highest-ranking countries in the GCI (known as the top ten economies). Next, the most competitive European economies (six countries) were identified and selected taking into account only the innovation component. Finally, the innovation-driven indicators influencing the competitiveness of the European economies were analysed.



**Figure 1. The analytical framework of the Global Competitiveness Index**

Source: own study based on WEF (2017).

The employment of secondary data analysis to determine the role of innovative competitiveness in the socioeconomic development of the European economies is the right approach for many reasons. Firstly, these data include extensive test research regarding a large number of enterprises in different countries and from various industries. It is to stress that the high sample size, representativeness and number of observations leading to broader applications provide sufficient information to assess the external validity of the data. Moreover, external validity can be considered as a generalizability of the research results (Bryman & Bell, 2007; Crowther & Lancaster, 2008). Validity is important because it can help to determine using methods that are not only ethical and cost-effective, but also methods that truly measure the research idea or construct. In this study, the innovation-related issues in context of competitiveness are the main research construct. Secondly, the secondary data enables not only to describe reality but also to verify previously accumulated knowledge based on publicly available data. This leads to high quality results through the possibility of eliminating questionable and incomplete materials, and reduce the risk of participating in the study by people with limited knowledge and competence (Vartanian, 2011; Johnston, 2014). Thirdly, existing data support re-examination, and thus create the possibility of replication. This is especially important in providing the reliability of the research analysis (Easterby-Smith, Thorpe & Lowe, 2002; Crowther & Lancaster, 2008). It should be emphasized that the use of secondary data analysis methods in this article allows answering the main research question of how innovations determine development of the most competitive European economies?

## RESULTS

### Quantitative synthesis of the most competitive European economies

Given the research objective, first the relevance of Global Competitiveness Index (GCI) for assessment of the socioeconomic development of the most competitive economies was carried out. The GCI is conducted annually by the WEF in order to compare the conditions for economic development in countries around the world. Based on the GCI from 2017, which includes data from 137 economies, the top ten economies with the highest rank in



the Global Competitiveness Index 2017-2018 were identified. Over the recent couple of years six European countries remain in the top ten (Table 1). These are Switzerland, the Netherlands, Germany, Sweden, the United Kingdom, and Finland.

**Table 1. Comparisons of the top ten economies in the Global Competitiveness Index**

Economy	2017-2018	2016-2017	2015-2016	2014-2015	2013-2014	2012-2013
	Rank (out of 137)	Rank (out of 138)	Rank (out of 140)	Rank (out of 144)	Rank (out of 148)	Rank (out of 144)
<i>Switzerland</i>	1	1	1	1	1	1
United States	2	3	3	3	5	7
Singapore	3	2	2	2	2	2
<i>Netherlands</i>	4	4	5	8	8	5
<i>Germany</i>	5	5	4	5	4	6
Hong Kong SAR	6	9	7	7	7	9
<i>Sweden</i>	7	6	9	10	6	4
<i>United Kingdom</i>	8	7	10	9	10	8
Japan	9	8	6	6	9	10
<i>Finland</i>	10	10	8	4	3	3

Source: own study based on WEF (2017).

As the table illustrates, Switzerland has remained at the forefront of the ranking since 2012, with strong results being at the similar level regarding the different components. The economic results are reflected in strong foundations, including public health, basic education, and a relatively stable macroeconomic environment. The Swiss economy is characterised by high flexibility and its labour markets are recognised as the best functioning in the world (WEF, 2017).

Beside Switzerland, which remains at the top of the overall ranking, also the Netherlands, Germany, Sweden, United Kingdom and Finland maintain their high position in the GCI 2017-2018. Taking into account the last decade, in the most European countries significant improvements of their innovation ecosystems (e.g. the quality of scientific institutions, company spending on R&D, and firms' capacity for innovation) can be seen. Data also point out that economic activities in the macroeconomic environment across the EU are currently strengthening (European Union, 2017). However, for a number of European economies, the GCI illustrates a deterioration in education indicators (e.g. the quality of the education system, primary education, and maths and science). Some weaknesses have also occurred in the transparency of the policymaking process as well as the security situation in several European countries. Based on these synthetic results for six European economies measured by 12 different components, it can be concluded that the GCI enables a comprehensive assessment of the competitiveness level of individual countries, and thus of their socioeconomic development.

### **Innovation-driven factors influencing competitiveness**

Furthermore, the aim of the research analysis is to indicate the role of innovation in competitiveness development. In order to examine this relationship, the innovation-driven factors influencing competitiveness were analysed. These GCI results show that in terms of innovation the best European countries are: Switzerland (1st), Finland (4th),

Germany (5th), the Netherlands (6th), Sweden (7th), and the United Kingdom (12th). According to the WEF (2017), innovation is essential for economies that approach the limits of knowledge, where the ability to generate growing value only through the integration and adaptation of exogenous technologies tends to disappear. The key feature of such economies is that companies must design and develop state-of-the-art products and processes to sustain a competitive advantage and move to activities with an even higher added value. This development requires an environment that fosters innovative activities by both the public and private sectors, for example through sufficient investments in R&D, in particular by the private sector, the high-quality R&D institutions, wide cooperation in research and technological development between industry and universities as well as protection of intellectual property.

A detailed analysis of the ranking positions shows that innovations can be considered an important stimulant of competitiveness development, and therefore the socioeconomic development of the European economies. In order to find out on which factors the development of innovation in European countries is dependent, available GCI innovation-driven indicators were analysed. The innovation component of the GCI comprises indicators on the capacity for innovation, the quality of scientific research institutions, university-industry collaboration, government procurement of advanced technology products, company spending on R&D, availability of scientists and engineers, and patent applications (Table 2).

**Table 2. Rank of European countries in the GCI 2017-2018 based on innovation-driven indicators**

Countries	Rank in the GCI Innovation pillar	GCI Innovation-related indicators						
		Capacity for innovation	Quality of scientific research institutions	Availability of scientists and engineers	University-industry collaboration in R&D	Government procurement of advanced technology products	Company spending on R&D	PCT patents (applications/million population)
Switzerland	1	1	1	12	1	37	1	3
Finland	4	7	8	1	4	20	7	4
Germany	5	5	11	11	7	6	4	7
Netherlands	6	6	4	19	5	19	8	9
Sweden	7	4	13	20	10	17	6	2
United Kingdom	12	11	2	17	6	24	14	18

Source: own study based on the WEF (2017).

Analyzing the country rank according to these indicators, there is a more differentiated level of development, despite the fact that Switzerland is still a GCI leader. The ranking indicates that a strong point in Switzerland's competitiveness is the highest place referring to four indicators: capacity for innovation (1st), quality of scientific research institutions (1st), university-industry collaboration in R&D (1st), and company spending on

R&D (1st). However, Switzerland holds a relatively low position in two areas, i.e. availability of scientists and engineers (12th) and government procurement of advanced technology products (37th). It is not only Switzerland but also most of these countries, which show a weak rank in these two last areas except for Finland (1st in the field of availability of scientists and engineers) and Germany (6th in the field of government procurement of advanced technology products). The only indicator illustrating a clearly high position of European countries in the GCI top ten is extensive business and university collaboration in R&D, where all six countries ranked in the top ten.

Furthermore, it is necessary to highlight that the GCI indicators measuring the influence of innovation reflect both demand-side as well as supply-side innovation factors. While the supply-side factors are in fact designed to support the innovation process, the demand-side factors aim at addressing and shaping the ecosystem of firms. Based on these indicators, the results for the six most competitive European economies show that demand-side innovation factors comprise measures to stimulate private demand for innovation and intelligent and pre-commercial procurement policies. Based on the GCI the following demand-side indicators can be identified:

- companies' capacity to innovate,
- fostering innovation by government procurement decisions,
- patent applications.

Supply-side innovation factors rely heavily on the role of research and technological development. They comprise incentives and direct support to R&D and innovation, skill upgrade, and human resources policies, collaboration for R&D, and networking strategies. Taking into account the GCI the following supply-side innovation indicators can be determined:

- assessment of the quality of scientific research institutions among the best in the world,
- companies' investment in R&D,
- collaboration of businesses and universities on R&D,
- availability of scientists and engineers.

The presented GCI analysis points to the key lessons and challenges relevant to socioeconomic progress. These factors determine the development of a new quality of socioeconomic development by innovative competitiveness. This requires active cooperation between the state (e.g. legal regulations) and the market (e.g. internationalisation of enterprises, increasing competitiveness), as well as science and politics. It can be concluded that all countries need effective recommendations for innovative competitiveness at microeconomic level which affects the social and economic policy that generates national prosperity.

## DISCUSSION

The research analysis provides, on the one hand, theoretical insights into how innovations determine competitiveness development and, on the other hand, it examines innovation-driven factors influencing the most competitive European economies. The research shows that, from the perspective of socioeconomic development at the macroeconomic level, activities at the microeconomic level play a key role. The study theorises that innovation exerts a positive force on competitiveness. In particular, competitiveness between enterprises is of great interest for many economists, because the companies are the key source

of real economy, and their behaviour depends largely on the condition, directions and pace of the development of national economies and people's standard of living. Companies contribute – as the key market players – to the emergence of new technologies, products and services, thus striving to gain a competitive advantage, which affects not only socioeconomic development, but also the progress of civilisation.

Considering the turbulent and rapidly changing environment, it can be stated that modern enterprises must constantly verify their basic strategic assumptions because they are under very strong pressure of changes and emerging innovations. Innovation and productivity growth – not economies of scale – will be crucial to achieving competitiveness in the long term. Innovation motivates firms to strive for a competitive advantage, which in turn allows to achieve a technological progress and economic growth at the macro-level. Porter (1990) also pointed out that competitiveness depends on long-term productivity, developed by a business environment that supports continual innovation in products, processes and management. Innovations are perceived as a way for coping with socioeconomic challenges. This study adds to the previous scientific findings that the competitiveness is largely driven by innovation (Brem, Maier & Wimschneider, 2016; Clark, 1961; Porter, 1990).

Based on these assumptions, the concept of innovative competitiveness has been proposed here. This concept goes beyond the conventional approach of market competition. It leads to a unique combination of innovation and competitive advantage. In spite of synthetic research analysis in this article, the concept of innovative competitiveness is perceived as a relative rather than an absolute concept as it is influenced by different factors. The results of this study demonstrate that the degree of innovation within the GCI depends on many drivers. Based on innovation-driven indicators, the most competitive European economies were identified. This allows not only for the benchmarking of nations (Berger, 2008) but also showing innovation priorities at the company level. The results of the six most competitive European economies show that both demand-side and supply-side factors are important for innovative competitiveness.

The findings of this study are consistent with the current priorities at the EU level. Innovation has been pushed forward to the top of the priorities, exemplified by strategies such as: the Europe 2020 strategy, as well as the Flagship Initiative “Innovation Union”. The EU's innovation policy focuses on a more integrated policy approach for improving the efficiency and effectiveness of research and innovation (R&I) systems at the regional, national and EU levels (European Union, 2015).

However, presently there has been a strong surge of policy interest in Europe on demand-side instruments (Edler & Georghiou, 2007). Thus, more attention is paid to the demand-side innovation policies such as: raising awareness, behavioural changes, promoting diffusion and absorption, involvement of (end-users), societal transformation processes, and promoting use of new business models (European Union, 2013). Integrating demand-side innovation issues into the mainstream policy instruments (innovation supply / R&D-oriented) is important because it supports companies in using innovation subsidies on R&D not only for product innovations, but also process innovation (e.g. implementing environmentally friendly technologies and energy efficiency), organisational innovations (changing the business model, implementing disruptive solutions), and market innovations (adapting solutions to other sectors or for internationalisation). The reason for increasing the role of demand-side factors relates to the fact that the nature of innovation has shifted

over the last decade: from being driven by people working within well-defined borders of corporate or university laboratories towards innovations that are increasingly emerging from the distributed intelligence of the global crowd (Ito & Howe, 2016). The key factor supporting innovative competitiveness seems to be the constant improvement of framework conditions, based on a stable law-making system, the cohesion of economic policy, and the dialogue between entrepreneurs and politicians.

## CONCLUSIONS

Referring to the main thesis in this article, it can be stated that innovative competitiveness is an important factor not only for stimulating the innovative actions of enterprises but also for effective shaping of socioeconomic development. Changes both in national economies as well as in the global economy, are inherently connected with innovative processes, which, by creating a new economic structure, alter the character and dynamics of economic development. Economies open to ground-breaking innovations, as well as those undergoing a process of “creative destruction”, create greater opportunities for dynamic social and economic development. This is done by changing the production structure and creating a new economic order, based on innovative enterprises. It is owing to competitiveness that better and better products are being offered, and companies are forced to innovate and conduct a reasonable pricing policy. The competitive ability of an enterprise depends not only on how it implements its basic economic goals (e.g. profit, profitability and liquidity), but also on whether it takes into account diverse political, legal, economic and social influences.

This article was aimed at analyzing the role of innovation in competitiveness development and identifying the most competitive European economies. Firstly, the framework of an innovative competitiveness was proposed. Secondly, the analysis concerned the most competitive European economies and indicates that innovation is an important factor in competitiveness development. The results provide valuable insights into how innovations determine development of the most competitive European economies. Measuring competitiveness relies on taking into account both supply-side and demand-side indicators. Based on the GCI the following demand-side indicators were identified: companies’ capacity to innovate; fostering innovation by government procurement decisions; patent applications. The supply-side innovation indicators are pertinent to: assessment of the quality of scientific research institutions among the best in the world; companies’ investment in R&D; collaboration of businesses and universities on R&D; availability of scientists and engineers.

Although the research results are encouraging, they are tempered by some limitations. This study focused only on innovation-related issues of the most competitive European countries, and is therefore limited by contextual factors, namely, the GCI’s innovation indicators and geography context (selected EU countries). Nonetheless, the research supports theoretical principles extending beyond the countries analysed that can potentially be referred to other GCI components. Another limitation of the study lies in having focused on the specified indicators, without carrying out further research based on other reliable data, dealing with similar issues. Future research should consider other data sources in order to conduct a comparative analysis, which could provide better insights into influencing factors of innovative competitiveness. The comparative studies could also

provide both better contextualization of new research results and a comprehensive conceptualization of innovative competitiveness.

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# The role of commercial diplomacy in promoting and facilitating international business

Agnieszka Hajdukiewicz

## ABSTRACT

**Objective:** The main aim of this paper is to examine the role and challenges of contemporary commercial diplomacy in business promotion and facilitation of international trade and investment.

**Research Design & Methods:** The research methods include the critical review of existing literature, analysis of relevant legal and official documents and the case study of the Polish model of commercial diplomacy.

**Findings:** The research revealed that with transformation of the world's economy and trading system, the scope and focus of commercial diplomacy tend to change. The activity of commercial diplomats increasingly focuses on promoting national brand and strengthening the image of national companies, discovering more tailored and "hidden" information, expanding tourism and attracting FDIs. One of the main priorities of commercial diplomacy is to support small and medium companies (SMEs) in their first steps to be made in foreign market. The Polish organization model of commercial diplomacy is currently undergoing major reform in the course towards improving the government-business relationship and increasing the efficiency of trade and investment promotion activities through eliminating of tasks duplication.

**Contribution & Value Added:** The research provides a deeper understanding of rationale of commercial diplomacy and its complex determinants, and it allows to formulate some indications for governments and businesses on how to better use diplomatic tools in achieving internationalization goals.

**Article type:** research paper

**Keywords:** commercial diplomacy; international business; international trade; trade promotion; business facilitation

**JEL codes:** F19, F20, F23, F50, H79

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## INTRODUCTION

In the age of enhanced globalization and competition, both governments, transnational corporations and NGOs need highly specialized knowledge in the field of diplomacy to face the complexity and uncertainty of the modern world and to build a proper image, competitive position and to promote their interests in the international arena. There are different types of diplomacy and diplomatic activities; this paper focuses on commercial diplomacy (CD) and its importance for expanding business internationally.

The paper assumes that commercial diplomacy, as a government service to the business community, provides an important mean to support domestic companies that want to enter new markets and to explore new export opportunities. Public sector involvement in the form of commercial diplomacy seems to be a crucial condition especially for small and medium companies that are newcomers to foreign markets, where the economic, regulatory and socio-cultural context for doing business differs from the one that they are accustomed to. Commercial diplomacy is believed to play also an important role in attracting foreign direct investment (FDI) to the home country. However, it has to be noted that there are still too few scientific studies, which look in detail into the modern functions and tools of commercial diplomacy.

Governments undertake business promotion and facilitation activities to encourage competitiveness of their economies in order to respond to new opportunities and threats of global markets and thus to secure both domestic economic interests and global competitive position. Consequently, trade and investment promotion, is likely to be one of the most important functions of overall diplomacy.

The main purpose of this paper is to examine the role and challenges for contemporary commercial diplomacy as a business promotion and facilitation activity. In particular, this paper analyzes the concept, functions and determinants of modern commercial diplomacy, taking into account its global and national context.

The research methods include the critical review of existing literature, analysis of relevant legal and official documents and the case study method. The case study of the Poland's organization model of diplomacy, presented in this paper, highlights the need to use and adapt the tools and structures of commercial diplomacy to meet the new challenges of a global marketplace.

## THE LITERATURE REVIEW

### Concept and scope of commercial diplomacy

In the academic literature a number of definitions of the term "commercial diplomacy" can be found and there is no agreement about its extend. In particular, the concept of "commercial diplomacy" in relation to "economic diplomacy" is often elaborated and interpreted in many different ways. Proposed definitions also vary according to the types of actors (public and private) that are involved in diplomatic activities as well as the scope of the issues that provide its content.

Some authors argue that commercial diplomacy is a part of economic diplomacy. Economic diplomacy can be defined as diplomacy where diplomatic means are used to achieve economic, foreign policy goals (Reuvers & Ruël, 2012). Okano-Heijmans (2011)

defines economic diplomacy as “the use of political means as leverage in international negotiations with the aim of enhancing national economic prosperity, and the use of economic leverage to increase the political stability of the nation” (p. 17). In her research, commercial diplomacy is one of the strands of economic diplomacy, alongside with trade diplomacy, financial diplomacy, inducements, and negative sanctions. The author understands commercial diplomacy as cooperative efforts by government and business that aim to achieve commercial objectives that advance national interests, including trade and investment promotion. However, the different strands of economic diplomacy may overlap, implying that economic diplomacy is not a linear, but more of a network concept (Okano-Heijmans, 2011). According to Potter (2004), economic diplomacy and commercial diplomacy are irrevocably intertwined since CD aims at exploiting the opportunities that are more or less created via the other strands of economic diplomacy. Reuvers and Ruël (2012) use “commercial diplomacy” as an umbrella term for both – economic and commercial diplomacy, since according to them in practice there is not much of a differentiation between the two. They define commercial diplomacy as follows: “Commercial diplomacy is the use of diplomatic means to support commercial activities, such as export and foreign direct investment (FDI) promotion. It is pursued with resources available to the home country, aiming at outputs such as economic stability, home country welfare, and a national competitive advantage. ... Commercial diplomacy functions is an umbrella term, including nation branding and participation in multilateral meetings, such as those of the WTO, and rewarding and sanctioning other countries in order to achieve foreign policy objectives.” ( Reuvers and Ruël, 2012, p.5 ). For Feketekuty (2012) commercial diplomacy is designed to influence government policy and regulatory decisions that affect global trade and investment. It involves the application of advocacy tools to government policies that affect international commerce.

Mercier (2007) notes that the concept of commercial diplomacy is usually interpreted in two ways. On a more general level, “as being a part of economic diplomacy”, that is related to economic policy issues. This broad definition seems to be more concerned with negotiations of trade agreements and their implementation. If narrowed on a micro level, the definition of commercial diplomacy focuses on “supporting trade and inward as well as outward investment”. According to Visser and Ruël (2012) commercial diplomacy features two types of activities: policy making and business support.

A number of authors more clearly distinguish economic diplomacy from commercial diplomacy and emphasize that commercial diplomacy, as opposed to economic diplomacy, focuses on business support and promotion and that is a more entailing concept than trade and export promotion. Kostecki and Naray (2007) use the term commercial diplomacy to cover business-support activities performed by the members of diplomatic missions, their staff and the related agencies. In their interpretation, commerce refers not only to trade but also to those activities related to investment, tourism or intellectual property. They define commercial diplomacy as “a government service to the business community, which aims at the development of socially beneficial international business ventures” ( Kostecki & Naray, 2007, p.1). Yakop and van Bergeik (2009) define commercial diplomacy as activities carried out by public officials from diplomatic missions, Foreign Affairs Ministry and other government departments, aimed to support the promotion of foreign direct investment and international trade by supplying information and advice about

trade and investment opportunities and by organizing and helping to act as hosts to trade missions from the home country. Berridge and James' definition of commercial diplomacy refers to the work of diplomatic missions in support of the home country's business and finance sectors and includes the promotion of inward and outward investment as well as trade (Berridge & James, 2003). Naray (2008) defines it as: "an activity conducted by public actors with diplomatic status in view of business promotion between a home and a host country. It aims at encouraging business development through a series of business promotion and facilitation activities" (p. 2). According to Saner and Yiu (2003) economic diplomacy which is concerned with economic policy issues, e.g. works of delegations at standard setting organizations such as the World Trade Organization (WTO), should be distinguished from commercial diplomacy which covers the work of diplomatic missions in support of the home country's business and finance sectors in their pursuit of economic success and the country's general objective of national development.

In most of definitions (Naray, 2008; Saner & Yiu, 2003; Yakop & van Bergeik, 2009), commercial diplomacy covers activities conducted by public actors, but not necessary with the diplomatic status (Kostecki & Naray, 2007). Diplomatic activities conducted by private actors, Saner and Yiu (2003) don't consider as commercial diplomacy, they count them to corporate or business diplomacy. However, Lee (2004) suggest that both public and private actors provide commercial diplomacy services; he defines commercial diplomacy as "the work of a network of public and private actors who manage commercial relations using diplomatic channels and processes" (p. 51).

The activities identified by Saner and Yiu (2003) in the area of commercial diplomacy include the promotion of inward and outward investment as well as trade. Important aspects of commercial diplomat's work is reporting to the home country about export and investment opportunities and organizing and acting as hosts to trade missions from their home countries. They can also promote economic ties through advising and support both domestic and foreign direct investors. For its part, Naray (2008) identifies five areas in which commercial diplomats operate and six types of activities they perform. Five areas include: promotion of trade in goods and services, protection of intellectual property rights, cooperation in science and technology, promotion of made-in and corporate image, and promotion of FDI. The activities in these areas cover: intelligence, communication, referral, advocacy, co-ordination, and logistics. According to the Busshers and Ruël (2012) the concept of CD can best be described by its observable business promotion services.

## MATERIAL AND METHODS

The paper addresses the issue of the role of commercial diplomacy in promoting and facilitating international trade and investment. The link between commercial diplomacy and international business development is examined through reviewing secondary source materials and using case study method. The results of several theoretical and empirical studies on commercial diplomacy and its effectiveness are presented and discussed in the paper.

The literature search was focused mainly on scientific articles from peer review journals. This search was conducted using major entrepreneurship research academic databases, such as EBSCO and JSTOR. Equally important, academic browsers such as Science Direct, Springer Link, and Google Scholar were used. The search was established without limiting

the period of publication, which allowed to track the origin of the discussion about the role and challenges of commercial diplomacy in supporting international business development.

First, in order to achieve the goal of the paper, the main benefits and rationale for commercial diplomacy are explored and assessed, with a particular focus on trade effects. Then, factors influencing commercial diplomacy are identified and discussed. The current challenges for commercial diplomats and the process of reforming and adjusting institutional models of CD to changing external and internal environment are examined, based on the case study analysis of the Polish model of economic diplomacy.

## RESULTS AND DISCUSSION

### Benefits and rationale of commercial diplomacy

Since commercial diplomacy is publicly funded, the justification for using it needs to be based on an assessment of the shortcomings and benefits associated with the CD services. Reuvers and Ruël (2012) state that both business enterprises as well as the governments and society can be beneficiaries of commercial diplomacy. In their input-throughput-output model of CD they identify political and economic benefits of commercial diplomacy, stressing that commercial diplomacy should be a value added activity. Political benefits include job creation, increased tax revenues and stimulation of economic growth, while economic ones comprise such outcomes of commercial diplomacy as trade increase, nation branding and welfare increase. Naray (2008) posed six rationale for commercial diplomacy: (1) the need for access to reliable and neutral business information; (2) support for the newcomer's weak credibility and image in foreign markets, (3) partner search: encouragement of national firms (mainly SMEs) to internationalize, (4) conflict handling, (5) support of home country delegations to the host country, and (6) strategic concerns, such as government endeavour to engage in strategic trade policies, support for R&D activities or access to supplies for energy resources and other materials. He also stated that the main direct beneficiaries of CD are private business firms, but governments can also benefit from the CD services. Successful companies may improve the country's and the government's image. Also, if international business is developed successfully through CD, the home country's economy and very likely also the host country's economy will benefit from enhanced economic exchange and integration.

In his newer research, Naray (2012) focuses on advantages of using CD from a business perspective. He states that there are both practical and symbolic reasons why business people trust the institutions of commercial diplomacy and often use its services. The advantages of commercial diplomacy are connected to considering it as: (1) central platform for international business to government relations; (2) activities being characterized by neutrality and credibility; (3) support in the first steps to be made in foreign markets (good price/quality ratio). In his view, commercial diplomats offer a centralized platform with the location in the "target market" from a business perspectives, offering general and specific knowledge about it.

Thanks to the centralization of governmental support and the resulting economy of scale, commercial diplomats can conduct business facilitation and promotion activities with lower costs (Villanueva Lop, 2017). Furthermore, commercial diplomats have better access to decision-makers, such as executives of large corporations, policy-makers, elites in the

host country, having possibility of linking business with politics. Neutrality as an attribute of CD means that firms are not discriminated against their competitors. By credibility it is meant that diplomats in general enjoy good reputation, and are considered to be well informed about political and economic affairs. Moreover, commercial diplomacy as a form of governmental support services is to high extend focused on small and medium enterprises (SMEs) (Busschers & Ruël, 2012). On one hand, the SMEs have a growing capacity to drive the economic development of a nation and their role in the economy is increasing. On the other hand, in their internationalization process they have a higher exposure to trade barriers, compared to the larger companies. According to the OECD, the main internationalization barriers of SMEs are: the shortage of working capital to finance exports; limited information to locate/analyze markets, the inability to contact potential overseas customers; and, a lack of managerial time, skills, and knowledge. The market-entry function of CD is particularly critical for SMEs that are newcomers to a particular region (Naray, 2012).

Private companies rarely invest in acquiring knowledge by themselves, as it is a risky investment for them, so it is important to use the governmental intelligence service. However, information is more accessible for companies today thanks to Internet based information systems and to the improved transparency in business brought about by different organizations such as the WTO. Thus, the traditional intelligence function of a commercial diplomat is decreasing at the expense of more specific, "hidden" information and new forms of promotion events such as trade fairs or trade missions (Villanueva Lop, 2017).

Several studies have been carried out in the past to measure the results of export support programmes, both at the national and business level. At the national level, Coughlin and Cartwright (1987) found that a 100 US dollars rise in export promotion expenditures generated an increase by 432.000 US dollars in value of exports. The study by Rose (2005) showed that the presence of a diplomatic mission abroad (an embassy or a consulate) may have a positive impact on bilateral trade. Using the sample of 22 countries and about 2000 potential trading partners, he estimated that for each additional consulate abroad, exports increased by 6-10 percent. The finding that embassies and consulates do facilitate trade was confirmed by Bergeijk, de Groot, and Yakop (2011). At the business level, Gencturk and Kotabe (2001) found, based on a sample of 162 US firms, that the use of export support programmes increased profitability but not sales of these companies. The study by Yanopoulos (2010) revealed that some export services are more useful (e.g. foreign market information, finding agents/distributors) for companies than others (such as language training or export business planning). Justinek and Sedej (2012) state that governments should count on the positive effects of export support, such as boosting exports and consequently, economic growth, but the support measures have to work in practice.

At the same time, government intervention through economic and commercial diplomacy is criticized by some economists and accused of transferring resources to an export industry that potentially distorts the efficient outcome. Some neoclassical economists hold the ideal of no governmental interference. For them firms should be able to enter foreign markets on their own account and if they have to be supported by governments, then, this is perhaps because of their products or services are not competitive. These critics argue that commercial diplomacy implies a transfer of resources from the public sector to commercial activities while is not clear if the private benefits exceed the cost of providing the public service (Yakop & van Bergeijk, 2009). They believe that taxpayer's money

can often be wasted. However, most of economists provide justification for that governmental intervention (considered as “necessary evil”) based on the theory of asymmetric information and market failure. The competitive advantage of one company can limit ability of other firms to collect the knowledge needed in the process of internationalization. The task of CD is to address information asymmetry, imperfect networks and informal trade barriers, such as cultural or language barriers.

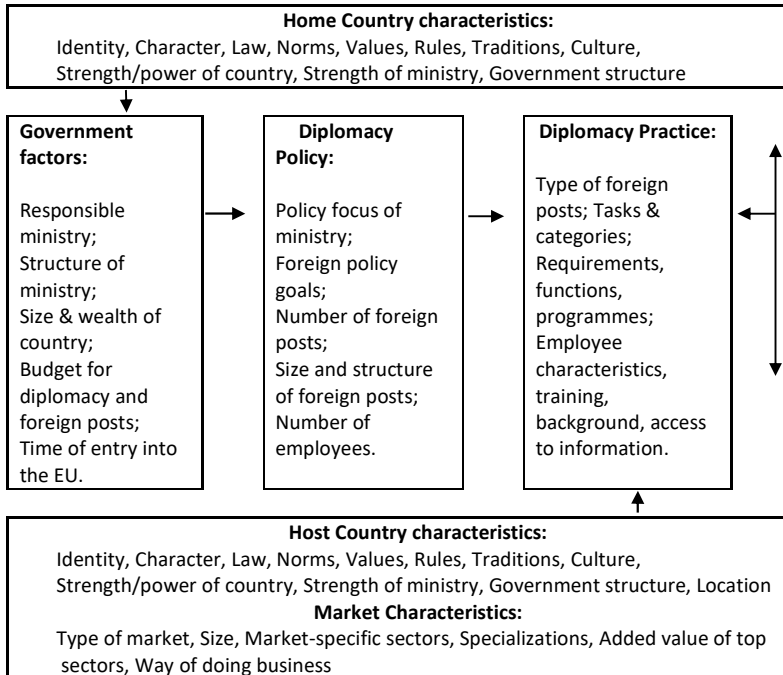
From a business perspective, there are some concerns related to the quality of information received from commercial diplomats and alternative actions. The leading concerns include their lack of practice and a “too general” overview, not very quick service and sometimes lack of updating. But the research conducted by Naray (2012) showed that companies often don’t know what commercial diplomacy can bring, what the company can expect from diplomats and how to contact them. This is not a lack of willingness to cooperate, but rather a misunderstanding of the services offered by commercial diplomacy.

### **Factors influencing commercial diplomacy**

In the modern economy many factors shaping activities and influencing effectiveness of commercial diplomacy can be identified. The external phenomena such as globalization and internationalization that encourage more political and economic interdependencies between countries, as well as technological advances and increasing influence of private actors are often discussed as the elements of commercial diplomacy context (Ruevers & Ruël, 2012). In addition to that a number of authors stresses the importance of both home and host country characteristics as determinants of CD. Concerning the home country’s features Ruevers and Ruël (2012) identify ministry structure and subsidiary level as key factors of the CD’s context, influencing its outcome. The home country influence was also elaborated in the study of Stadman and Ruël (2012). According to them country factors that specifically influence commercial diplomacy can be grouped into ones concerning the government of a country and its foreign posts. On the government level, the factors are: the ministry responsible for commercial diplomacy, its structure, the level of centralization/decentralization, the degree of independence of trade promotion organization (TPO) etc. On the foreign post level the commercial diplomacy practices are influenced by the structural form of the agencies responsible for commercial diplomacy and depend on the level of government (central, regional and local) where the services of these agencies are provided. The structural forms of these agencies can be divided into private, public or a mix of public and private. Based on foreign economic policy goals the foreign posts can use different programmes and practices for the promotion of export and inward investment (Figure 1). According to Mercier (2007) the export promotion programmes can be divided into market development programmes and export service programmes. Market development programmes are concerned with the generating of sales leads, the participation in trade shows, the preparation of market analyses etc. Export service programmes comprise holding seminars for exporters, providing them with export guidelines and helping with the financing of export. The factors influencing commercial diplomacy services at the foreign post level include also a number of diplomats and employees working there and their characteristics and types. Commercial diplomats often have different styles based on their approach to commercial issues and their leading concerns. Kostecki and Naray (2007) distinguish three basic types of commercial diplomats: business promoter (the business-oriented diplomat, closely cooperating and actively supporting business),



civil servant (the economic policy-oriented diplomat, who does the work that is requested by the ministry, in a mostly reactive way) and generalist commercial diplomat (the foreign policy-oriented diplomat, occasionally supporting business). In the classification by Galting and Ruge from 1965 three extreme types of diplomats were identified: the “elite-oriented”, that means a diplomat with a lot of connections, who usually comes from the upper class; the “treaty-oriented” diplomats, that should have a law background and be able to negotiate and draft agreements; and the “structure-oriented” diplomat, with a degree in social sciences, able to provide insight into the political, economic and social structure of the host country (Stadman & Ruël, 2012).



**Figure 1. Factors shaping commercial diplomacy**

Source: adapted from Stadman, & Ruël (2012, p. 190).

Among host country characteristics influencing the commercial diplomacy policies and practices Kostecki and Naray (2007) considers the host country’s market size and potential as the most significant determinants for investment in commercial diplomatic relations. Another factor of influence according to them may be “gravity center” or top sectors, implying that some countries are very important markets for certain products. Many authors add such factors as cultural, legal and political situation in the host country and historic background between home and host country, such as for instance colonial ties (Reuvers & Ruël, 2012). According to Cuero Acosta, Adu-Gyamfi, Nabi, and Dornberger (2017) entrepreneurial opportunity does not only emerge from the individual mindset, but can also have its origin in the external environment in which the entrepreneur operates. The challenges come from various external conditions such as financial volatility on markets, rapid technological innovation, changing customer preferences, the growth of new segments on

the market, culture, demographic rates, institutional framework conditions, macroeconomic conditions, and the natural environment.

Since commercial diplomacy should add value for clients firms, by offering activities or services that are relevant and of a good quality, Kostecki and Naray (2007) focus on determinants of value-added commercial diplomacy. They pose several propositions that might impact the activity profile, the business orientation and the performance of CD services. The propositions, are grouped into five categories: client characteristics, home country features, host country features, the global environment, and the commercial diplomacy arrangements. In this approach, apart from the external context of CD services, which was already mentioned above, the focus is to a big extend on a client firm characteristics. The preparedness of the firm which makes use of commercial diplomacy can be also an important determinant of CD effectiveness. Clients have to acquire some knowledge and skills to participate effectively in the service creation and delivery process. It is often the case that client firms do not positively participate in the service process, and they tend to be unprepared and their requests tend to be unspecific or unrealistic (Zuidema & Ruël, 2012). Therefore, the preparedness of a firm to go abroad, defined as a state of readiness for internationalization has to be taken into account. A distinction is often made between the firm's internal resources and capabilities used to deploy these resources. Resources are tradeable and non-specific, while capabilities are firm specific and used to engage resources within a company. Determinants of the commercial diplomacy linked to a firm's resources and capabilities include the size of a firm, the available business network in which a company can participate, the level of international experience of a firm and the degree to which they rely on foreign public customers and partners.

### **Evolving model of commercial diplomacy: the case of Poland**

The political and economic breakthrough in Poland in 1989, related to the fall of communism and the return to the market economy, did not imply an immediate change in economic diplomacy. The first Polish Minister of Foreign Affairs in the transformation period was in fact criticized for abandoning the construction of economic relations, not giving priority to economic diplomacy, and for the lack of strategies and structures, and deprecating the importance of diplomacy in the sphere of economy (Molendowski & Polan, 2007). The first bigger reform of the Polish economic diplomacy took place in July 1999 with the transformation of Commercial Counsellor's Offices (originating in communist times) into the Commercial and Economic Sections (Wydziały Ekonomiczno-Handlowe – WEH). These new units, functioning within diplomatic missions and consular offices, took over tasks in the field of economic relations as well as protection and promotion of Poland's economic interests abroad, thus constituting the institutional basis of Polish economic diplomacy. They were subject to the Ministry of Economy in respect of financial resources, staff and tasks to be performed. However, since their employees belonged to the Polish diplomatic corps, in their activities always the political and protocol primacy of the Embassy was emphasized. This model of economic diplomacy was the result of a compromise between ministries of economy and foreign affairs, that reconciled different concepts of commercial diplomacy in Poland, but for the most part it was criticized due to the lack of one centre with competences and resources in the area of eco-

conomic (export) promotion and coordinating all initiatives and projects in this field. Pursuant to the 2006 reform of the organizational model of Poland's economic diplomacy, WEHs were being replaced by: Economic Departments (Wydziały Ekonomiczne – WE) subject to the Ministry of Foreign Affairs, and Trade and Investment Promotion Departments (Wydziały Promocji Handlu i Inwestycji – WPHI) subordinate to the Ministry of Economy. The aim of this reorganization was to distinguish different functions of diplomatic missions: analytical – performed for the government administration, from the purely commercial ones, dedicated to the business community. Thus, competencies of WEs included the analysis of macroeconomic situation in inward countries and the application of bilateral economic policy of the Polish government, while WPHIs were responsible for the promotion of the Polish economy and business, supporting SMEs in their export activities, attraction of inward investment etc.

The 2006 reorganization of the Polish economic diplomacy didn't end the discussion on the model of Poland's commercial diplomacy. In recent years according to a number of experts, there has been still a need for further reforms, which could define more precisely the division of competences between the Ministry of Economy and the Ministry of Foreign Affairs. These reforms could improve the coordination of activities and cooperation between ministries in the field of business support on foreign markets. In particular, many claimed that the reform of 2006 was incomplete, because one of its main goals was to create a government agency responsible for supporting internationalization of Polish enterprises and attracting foreign investments to Poland, which, however, was not set up. Lack of such an agency resulted in poor synchronization of activities and has deepened an "atomization" of the promotion and support system, leading to some inefficiency of the existing solutions.

At the same time, Polish business is more and more interested in expansion into new foreign markets. Taking into account the overdependence of Polish exports on one market – the European Union's – which has recently been stagnating, the main goal of promoting the Polish economy should be to facilitate the expansion of companies in more distant non-EU countries. In markets located in South Asia, North America, South America, Africa, the Middle East, Polish products and services could exploit their competitive advantage thanks to their quality and competitive prices. However, distant markets although promising and increasingly attractive, but at the same time might be very difficult for new companies to enter due to the different economic, political, social and technological business environment and numerous entry barriers. The changing geography of Poland's global business presence will require the state's political support and trade promotion, which is often a necessary condition for undertaking commercial activities on a new foreign market. Since in the past the Trade and Investment Promotion Sections were located mainly in Europe, nowadays it would also require building a new network of Polish diplomatic and consular post and trade missions, in order to expand into new countries and cities.

Besides, Polish entrepreneurs believe that a poor recognition of "POLAND" brand in the world is a significant obstacle in their expansion on foreign markets. Especially in the service sector Poland has no strong image as a professional and reliable partner. Therefore, the government should intensify activities aimed at promoting the country brand in order to increase the visibility and attractiveness of products and services from Poland in global markets.

According to the Polish Foreign Policy Strategy for the years 2017-2021, important tasks in the area of economic expansion and brand building include (The Ministry of Foreign Affairs of the Republic of Poland, 2017):

- assisting Polish businesses in expanding onto new international markets, in particular by developing cooperation with Asian, African, Middle Eastern, and Latin American countries,
- seeking cooperation opportunities with non-European partners, especially the People's Republic of China, in the implementation of regional infrastructure projects,
- identifying and eliminating barriers to non-EU markets that are particularly cumbersome for Polish exporters,
- attracting more foreign tourists by promoting innovative tourism products,
- protecting and projecting Poland's reputation as part of our political and economic promotion.

To meet the above mentioned ambitious goals, Poland has recently taken steps to build a new model of economic promotion abroad.

The main element of the new reform of the Polish model of commercial diplomacy, was the establishment of The Polish Investment and Trade Agency as the central institution responsible for the economic promotion abroad and facilitation of foreign investment. Starting February 3, 2017, the Polish Investment and Trade Agency (PAIH), which is the joint-stock company with State Treasury as the only stockholder, replaced the Polish Information and Foreign Investment Agency (PAIILZ). This reorganization was much more than rebranding as it was connected with the expansion of the scope of the agency's activities. The Polish Investment and Trade Agency acts as the central point on the map of national economic agencies, engaged with foreign expansion of Polish entities, coordinating all operational instruments, such as diplomatic missions, commercial fairs and programmes dedicated to specific markets and sectors. It is in charge of the export promotion of Polish companies, especially small and medium enterprises, as well as for the promotion of the whole Polish sectors. Agency's mission is to create a positive image of Poland across the world and promoting Polish goods and services. The Agency is engaged with facilitating foreign investments in Poland, Polish investments abroad and also Polish investments in Poland, which is a much broader scope of investment-oriented activities as compared with the previous model, in which the PAIILZ's core operations entailed servicing foreign investors in Poland. It is also responsible for providing information on legal and economic environment and organizing information and promotion venues in Poland and abroad.

Another important element of the current reform is the departure from the Investment and Trade Promotion Departments (WPHIs), operating as it was mentioned above by embassies and consulates, subordinate to both the Ministry of Foreign Affairs and the Ministry of Economy. WPHIs are being successively closed and replaced (but not necessary in the same locations in which they used to operate) by commercial offices abroad, which are subordinate to the new Agency. Until April 1st, 2018, 29 Foreign Trade Offices have been established, including ones in such distant locations as Astana (Kazakhstan), Dubai (United Arab Emirates), Jakarta (Indonesia), Ho Chi Minh City (Vietnam) or Tehran (Iran). Ultimately, there will be 70 locations of Foreign Trade Offices in the world (The Polish Trade and Investment Agency [PAIH], 2018a). The services of Foreign Trade Offices in-

clude: helping to reduce business risk in foreign expansion by managing business information; selecting reliable business partners (they act as a “professional matchmaker” for Polish companies and foreign clients); arranging B2B talks; arranging trade missions and the presence of a client at trade shows; offering investment site advisory; getting the access to full range of business support tools offered by the Polish Development Found (The Polish Trade and Investment Agency [PAIH], 2018b).

The replacement of the old WPHIs with the network of foreign trade offices subordinate to the Polish Investment and Trade Agency (PAIH) is a qualitative rather than a quantitative change in the Polish commercial diplomacy model. These offices operate outside the structure of embassies, and their employees do not have diplomatic status. It lowers the operating costs of these branches, although at the same time it may somewhat weaken their credibility. It also implies direct subordination of the issues of commercial diplomacy to the ministry responsible for economy and development. The ministry intends to focus the Agency’s activity on potentially attractive for Polish exporters non-European markets, which are most often more difficult to reach than those geographically and culturally closer, especially those located within the framework of the European Union.

The resources within these support go first of all to those projects that have the best chance of success. Intensely promoted will be especially 12 industries, which were indicated in the “Strategy for Responsible Development” as the most innovative and prospective, and at the same time which can create the brand of Poland, which in the future will be strongly associated with Poland. These include among others yachts, furniture, cosmetics and medical equipment (The Ministry of Infrastructure and Development of the Republic of Poland, 2017). Under this program, entrepreneurs from twelve industries will receive assistance in creating and financing promotion programs, which will include not only participation in fairs, but also business to business meetings, bringing business partners to Poland, trips to meetings with a foreign contractor, consulting, training, etc., that is all that is needed to enter the remote market. These programs are financed mainly from European Union funds, but through the agency and with its active involvement.

The new system also assumes that foreign commercial offices in most cases operate in accordance with the commercial law. They can therefore conduct normal commercial and service activities. In addition, private companies will be able to participate in the promotion system of the Polish economy and will bear the costs of functioning of foreign trade offices. This therefore means, that there has been a transition from the public to the public -private commercial diplomacy model. This is also favoured by the human resources policy, which presupposes the preference for young people to work in foreign trade offices who are knowledgeable in foreign languages and are not only risk-tolerant but also have good connections with business and are able to create good relations with the local business environment. Some promotion activities are undertaken together with the Polish diaspora. It is expected that these changes will lead to closer cooperation between the administration and business, and will ensure the better adjustment of CD services to the needs of companies as well as increase the efficiency of the funds spent on the international business promotion.

Since new solutions to the Polish model of commercial diplomacy have been introduced only recently, it is too early to assess their impact on the effectiveness of the entire system, and especially on export results. Therefore, further research needs to

be carried out to examine if the export support offered within the new model affects exports and investment in Poland.

## CONCLUSIONS

With globalization of the world's economy and trading system, the importance of commercial diplomacy has been increasing, since companies that operate more and more internationally face many constraints and challenges due to complex business environment and global competition and they show a growing need for a government support in their efforts to exploit their competitive advantage in international markets. Governments respond to these needs and invest considerable amounts of public resources by being engaged in the activities which are nowadays fundamental for commercial diplomacy, i.e. facilitation of international business and export/business promotion. It is expected that this should, in turn, result in increased international economic integration, growth, and employment along with generating good bilateral business relations between countries.

While the main functions of commercial diplomacy remain unchanged, the scope and focus of CD activities has evolved during the years; nowadays the main tasks include strengthening a country's image, building country brands and enhancing the companies' credibility abroad, attracting more tourists by promoting innovative tourists products as well as facilitating FDIs. In the area of export promotion the commercial diplomacy is tasked particularly with supporting SME's, which on the one hand, have a growing capacity to drive the economic development of a nation, but the other hand, in their internationalization process they have a higher exposure to trade barriers, when compared to large companies. The function of supplying information, which is one of the main responsibilities of commercial diplomats, has evolved towards discovering more tailored and "hidden" information and public relations.

There are many external and internal factors that can determine the relevance and effectiveness of commercial diplomat's work. They can be grouped into such main categories as: the home and host country characteristics, government factors, diplomacy policy of a country and diplomacy practices. Some of them are reflected in a country's specific model of commercial diplomacy services. The Polish model of commercial diplomacy is currently undergoing major reform in the course towards improving the government – business relationship and increasing the efficiency of trade and investment promotion activities through eliminating of tasks duplication. The main element of this reform is the creation of The Polish Investment and Trade Agency as the central institution responsible for the economic promotion abroad and facilitation of foreign investment. It is set to play an important role in a modern mechanism of economic promotion abroad that effectively facilitates the internationalisation of Polish business and implements the Strategy for Responsible Development.

Since the study is an introductory one, and it faced some data limitations, only qualitative methods have been used to explore the potential the links between commercial diplomacy and international business development. Further research is needed to measure the impact of commercial diplomacy activities on international trade results, and in particular to investigate the link between export promotion expenditures and export performance.

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# Risk insights vs. competences in managing multicultural teams in Poland

Ludmiła Walaszczyk, Remigiusz Mazur

## ABSTRACT

**Objective:** The objective of this study was to obtain in-depth understanding of the concept of necessary competences, which could ensure effective work in multicultural organisations based on different risks, which can occur in practice.

**Research Design & Methods:** The authors made in-depth literature review in order to identify and to understand the possible risks that can occur in multicultural organisations and the behaviours of staff related to the risks identified. Afterwards, the authors made interviews with 30 people from multicultural organisations in order to finally present a qualitative analysis, which aimed at identifying and comparing competences, which seem to be necessary in order to work effectively in multicultural organisations.

**Findings:** Based on the feedback from the target groups, it turned out that the respondents admitted that it is necessary to have specific competences, which could support effective works in the multicultural organisation.

**Contribution & Value Added:** The core input is that the results of the study are not be only the subject of theoretical considerations, but they can be implemented in practice in the form of a dedicated training.

**Article type:** research article

**Keywords:** multiculturalism; cultural risk; cultural competences; intercultural management; cultural awareness of staff

**JEL codes:** D22, J24, J61

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## INTRODUCTION

In global economy, many enterprises of different size operate in multicultural environments, whether in dealing with clients or within their own workforces. Multinational working today necessarily involves establishing collaborative partnerships for the delivery of goods and services, and employees across the EU are increasingly required to

operate in a way, which demonstrates sensitivity and competence in dealing with people from different cultural backgrounds.

Nowadays, when the borders are opened, there is a strong need to focus on intercultural dialogue between people, who work together (e.g. Angouri & Glynos, 2009; Besley & Peters, 2012; Bikmen & Sunar, 2013; Choi, 2006; Lähdesmäki & Wagener, 2015; Wilk-Wos, 2010). Developing cultural competences results in an ability to understand, communicate with, and effectively interact with people across cultures, and work with varying cultural beliefs and schedules. However, people from different cultures vary in how, for example, they relate to many aspects. As the example of perceiving the term 'bad news' (Zahedi, 2011) – people from some Asian cultures are reluctant to give managers bad news – while those from other cultures may exaggerate it. Team-building issues can become more problematic as teams are comprised of people from a mix of these cultural types (Lisak & Erez, 2015). Effective cross-cultural team-building is essential to benefiting from the potential advantages of cultural diversity in the workplace. It is very important to consider the problems, which come from the multiculturalism. Problems with risk culture are often blamed for organisational difficulties but, until now, there was very little practical advice around on what to do about it. The objective of this study was to obtain in-depth understanding of the concept of necessary competences, which could ensure effective work in multicultural organisations based on different risks, which can occur in practice. The competences are understood in this paper as a set of knowledge, skills and attitudes as this approach is currently dominant in literature. The obtained research results, collected through the performance of the qualitative interviews, will enable to find out, which competences are needed in order to manage the multicultural company in a more effective way.

## LITERATURE REVIEW

There are a lot of risks in the functioning of the organisation (market, financial, legal, ecological, political), however taking into consideration the possibility of mixing people from different regions in the world, a cultural risk is dominant. People from different cultures present different approaches to work and they can understand many things in a different manner. That is why *'cultural risk is a journey with no end'*, which means that it cannot be compared with the risk process in general. It can be never completed. The success of international staff is assumed by psychological features, which cannot be modified, but they can be strengthened in order to be a strong side when working in intercultural organisation (Przytuła, 2011). That is why risk culture requires awareness at all levels of the company (Laycock, 2014), both personal and organisational. The state-of-the-art clearly shows that the main problems with the staff in the multicultural organisations are the following: lack of openness, lack of speaking in an understanding way, inability of speaking language of a country, lack of punctuality, different facial expression, etc. (Bucker & Beerlage, 2017; Chmielewska-Muciek, 2017; Fitzsimmons, 2013; Korzilius, Yeo & Pang, 2017; Panagiotis, 2012; Przytuła, 2011).

Companies from all over the world have its branches in Poland. Some of the Polish firms have changed as well – foreign investors become managers and administrative directors. Opening the borders made it easy for companies to entrance on new markets,

especially the European Union ones. Generally, international corporations charge experienced specialists with assistance at creation and opening of new branches. More and more organisations have contacts with representatives of different countries, societies and religion associations that serve as a sufficient base to launch cooperation.

In an increasing number of occupations, a large influx of foreigners (mainly Ukrainians) is observed (Skoczyńska-Prokopowicz, 2018; Zubik, 2014). The interest in foreigners is mainly related to building industry, construction and production, but employers are looking for specialists in the IT industry as well, because of an insufficient number of candidates on the domestic market.

Therefore, many risks may occur, mainly resulting from the lack of knowledge of different cultures. The risks related to the management and working in multicultural organisations in Poland are presented in Table 1.

In order to minimise or avoid cultural risks, the organisation must be interculturally competent (Brünnemann, 2013; Hammer, 2009; Jackson, 2015). Ideally, the whole organisation should become interculturally competent. However, this is of crucial importance to managers and employees in two important respects (1) they need to be interculturally competent to manage intercultural environments effectively and helping employees understand culture better and (2) develop the knowledge, skills and attitudes to operate effectively in an increasingly intercultural workplace (Lara & Salas-Vallina, 2017).

Organisations have a 'culture' of policies, procedures, programmes, and processes, and incorporate certain values, beliefs, assumptions, and customs (Zalina, Abdullah & Ismail, 2016). Organisational cultures largely echo mainstream culture in its sense of time orientation, perception, and use of time. An organisational culture may not naturally lend itself to cultural competence, so that is where skill building comes in. A culturally competent organisation brings together knowledge about different groups of people – and transforms it into standards, policies, and practices that make everything work (Lara *et al.*, 2017). There are some key elements that contribute to a system's ability to become more interculturally competent (Alegre & Chiva, 2013). In organisations intercultural competence would be characterised by: valuing diversity among staff; self-assessment; institutional cultural knowledge; adapting service delivery to reflect an understanding of diversity; openness and respect for diverse staff; a culturally diverse workforce; consciousness and management of difference; routine monitoring and evaluation of impact of policies and practices on cultural and ethnic groups (Davis & Cho, 2005; Lloyd & Hartel, 2010; Zimmermann, 2010).

The delivery of interculturally competent services cannot be divorced from the question of opening up the institution, as a starting point for staff to develop intercultural competence.

**Table 1. Risks occurring in multicultural organisations in Poland in today's economy**

Behaviour	Risk
Difference of intentions – people have in mind one thing, but they say something, which does not correspond with the first thought.	Language misunderstandings and lack of clarity in communication (Kostrzyńska, 2018)
Employer's care for adapting the working conditions to the needs of the others – it must be reflected in knowledge of legal aspects. Modern work methods, such as brainstorm, may not be stimulating for representatives of high-context cultures, who do not work in the same way as representatives of low-context cultures.	Different interpretation of the same situations; individualism vs. collectivism; unintentional offending (Kostrzyńska, 2018)
Lack of education of Polish supervisors in managing international teams – supervisors will often over-manage and get bossy. That will rattle the employees and the negative cycle is reinforced.	Decrease in efficiency, decrease employee morale (Rogowski, 2015)
Differences in management in Poland and other countries – for example Asian companies are not interested in participating and organising external training, because they all have developed procedures, technology and knowledge about their industry.	Ethnocentrism, individualism vs. collectivism, creation of sub-groups (Berłowski, 2014)
Complaint about bureaucracy and public sector employees' attitude by foreigners – they are also confronted with incompetence and complicated procedures in a system.	Decrease in efficiency, decrease employees' morale, language misunderstandings and lack of clarity in communication (Bilicka, Paszkowska-Rogacz & Stawiany-Marchwicka, 2006)
Usual requirement to communicate informally with all the workmates, regardless of their position in global companies having their branch in Poland – the Poles are not used to it and they prefer rather formal contact with management staff and they are afraid to break this barrier.	Unintentional offending, the sense of shame, creation of sub-groups (Wach, 2010)
Problem with acceptance of existence of different culture or religion in a working place – this prejudice is a result of false perception of so called 'strangers', 'others', 'different'. These reactions of distaste, disapproval or hostility are most often the results of ignorance. Lack of acquaintance of culture, tradition, religion or language of other nations, communities or groups leads to negative behaviours.	Creation of subgroups, stereotypes, ethnocentrism (Wojtulewski, 2016)
Different perception of time – monochronic cultures, such as Germany and Poland value punctuality and keeping to schedules. In polychronic cultures, such as the Middle East or Latin America, maintaining relationships and socializing is more important than the schedule. Differences in concepts of time can pose challenges for multinational companies in Poland.	Project delays, different interpretation of the same situations, ethnocentrism (Kosiu, Troncy & Golzhauser, 2005)
Implementation of various solutions without taking into account Polish specificity by many international organisations having their branches in Poland.	Decrease in efficiency, different interpretation of the same situations, creation of subgroups (Gajek, 2009)

Source: own elaboration.

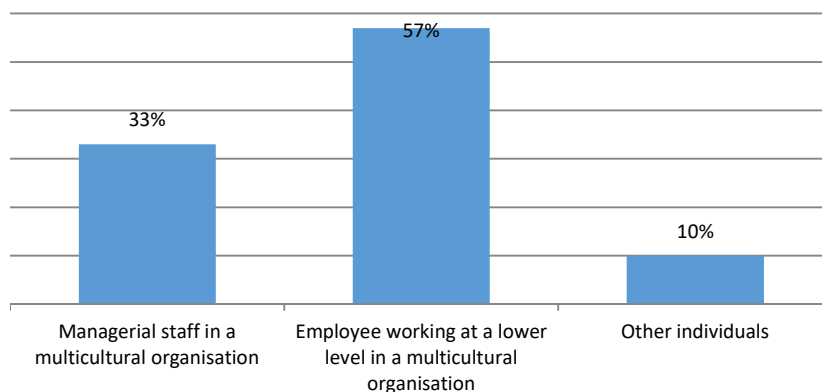
## MATERIAL AND METHODS

Due to the fact that the multicultural organisations are exposed to many risks coming from different cultures, the authors designed the questionnaire (see in Annex 1), which aimed at verifying, which competences are needed in order to minimise or even eliminate potential risks.

Therefore, the main research question was: What competences should be acquainted by the staff from multicultural organisations in order to be more effective in daily work?

The questionnaire included eight (8) parts, which were strongly related to the issue of the management and functioning in multicultural environment. The questionnaire was directed to the following target groups (Figure 1):

- Managerial staff from multicultural organisations;
- Employees working at lower levels in multicultural organisations;
- Other individual people, who had the contact in the past with multicultural organisations, and who faced the problem of risks coming from the culture diversity.



**Figure 1. Target group taking part in the research between 2018 and 2019**

Source: own elaboration.

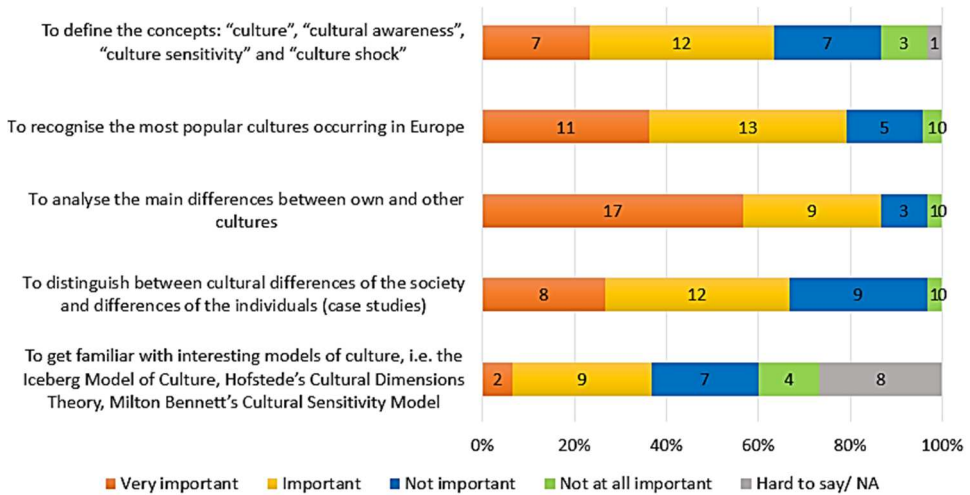
The questionnaire was directed to thirty (30) representatives of multicultural companies from Poland. The authors performed face-to-face interviews with the use of previously prepared questionnaire. All competences were evaluated by using the scale, where '4' means that competences are very important to be achieved, '3' means that competences are important to be achieved, '2' means that competences can be achieved, but they do not seem to be significant, and '1' means that competences are unnecessary to be achieved. All items also included a possibility to choose the answer 'hard to say', if an interviewee had a problem in deciding. For data processing, the program IBM SPSS Statistics 22 was used.

The data, which were collected in the study achieved an overall norm of between 15 and 60 participants for qualitative interviews within Organisational & Work studies. In the opinion of Marshall, Cardon, Poddar & Fontenot (2013) "this norm indicates that the number of participants likely to be considered sufficient is both more varied and greater than

the 15-30 participants suggested by empirically justified guidance, and all expert opinions reviewed other than Adler & Adler (2012) who advise between 12 and 60" (p. 34).

## FINDINGS AND DISCUSSION

The questionnaire results show that the majority of interviewees agreed that competences listed in the questionnaire are 'very important' and 'important'. Only a few of them answered that those competences are 'not important' or 'unnecessary'. The answer 'hard to say' was chosen only a few times. Detailed analysis is presented below.



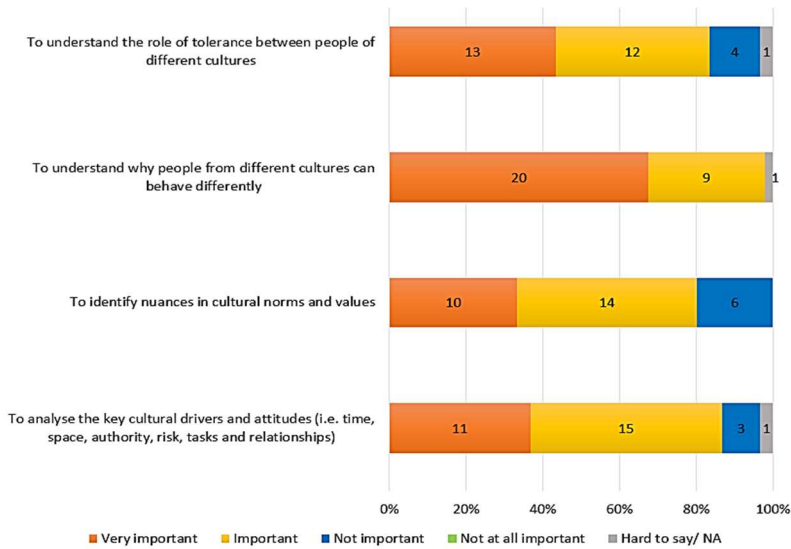
**Figure 2. Cross cultural awareness**

Source: own elaboration.

The interviewees acknowledged that according to them, the least valuable competence is 'to get familiar with interesting models of culture, i.e. the Iceberg Model of Culture, Hofstede's Cultural Dimensions Theory, Milton Bennett's Cultural Sensitivity Model'. It received 23% of the 'not important' and 13% of 'unnecessary' answers. This competence had also 27% 'hard to say' answers. Taking into account different respondents, it turned out that managerial staff agreed that very important or important are the following competences: to recognise the most popular cultures occurring in Europe and to distinguish between cultural differences of the society and of the individuals. Similarly, employees from lower level also agreed that the most important competence is to know the differences between societies and the individuals as it improved the effectiveness of work between multicultural staff in the organisation.

It comes from the fact that the respondents are not interested in scientific aspects of culture. They prefer knowing practical aspects, which can be met in everyday work in the multicultural organisations. It can be observed that the competence 'to analyse the main differences between own and other cultures' was assessed as the most important. It can result from the fact that many people identify the own culture with the other ones, not seeing any big differences. Therefore, many conflicts or misunderstanding can

occur. It is confirmed in literature, among others, by Chaney (2005), Milfont (2012) or Gut, Wilczewski & Gorbaniuk (2017).



**Figure 3. Understanding different cultures**

Source: own elaboration.

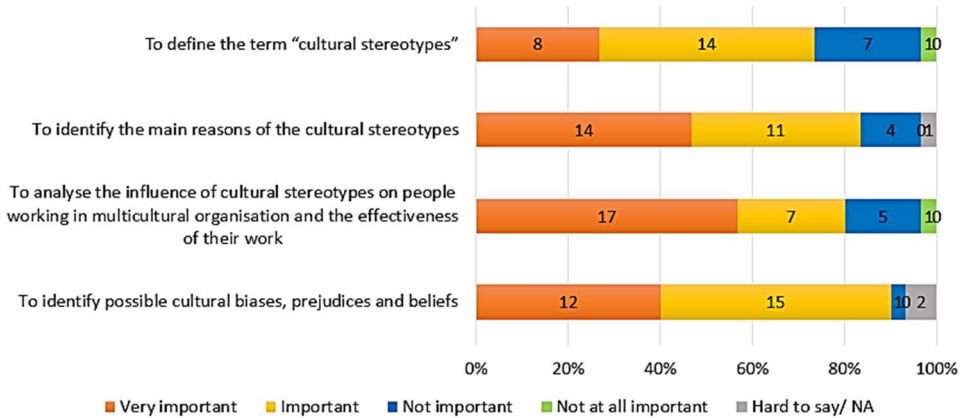
In Part 2, the interviewees were obliged to answer, which competences are desirable to better understand other cultures. The vast majority of the respondents recognized that all the competences are important. The highest percentage (70% ‘as very important’ and 30% as ‘important’) were related to the competence ‘to understand why people from different cultures can behave differently’. Such responses can show that the respondents relate the competences to practical situations, which can be met in everyday life. Employees from lower level highlighted that crucial is to recognise and understand why people from different cultures behave differently. If it is recognised, it is then easier to predict the behaviour of the colleagues from the working organisation. Managerial staff underlined that the employees should understand the role of tolerance between people of different cultures. It was the core competence for these respondents as they think that without being tolerance, the atmosphere in the workplace is not good.

Based on the results in Part 2, it can be seen that among the interviewees the most important is to understand the behaviour of culturally different people and understand the role of tolerance in order to improve their work in the organisation. In literature it is confirmed, among others, in the works of Serin (2017) or Spencer-Rodgers, Williams & Peng (2010). None of the competences was considered as ‘unnecessary’ in this module.

In Figure 3, the respondents were asked questions about competences that can support understanding and overcoming cultural stereotypes. The most important competence turned out to be ‘to identify possible cultural biases, prejudices and beliefs’ (both for managerial staff and employees from lower level in a multicultural organisation), which obtained 40% as ‘very important’ and 50% as ‘important’ answers. It came from



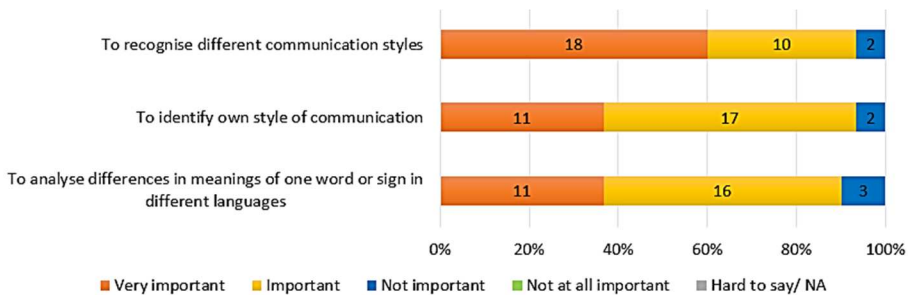
the fact that people are very sensitive when comparing different religions or beliefs. Unfortunately, it often results from the lack of knowledge on the issue (Matusitz, 2012). The least important competence in Figure 3 (23% as ‘not important’, 3% as ‘unnecessary’) was related to ‘to define the term *cultural stereotypes*’. Employees from lower level underlined that all competences, which concern the definitions are unnecessary, because it is crucial to be able to do, and not to know.



**Figure 4. Stereotypes**

Source: own elaboration.

The results clearly indicate that the respondents considered understanding and breaking stereotypes as crucial in improving cooperation in the organisation. The choice of the least important competence may suggest that the majority of respondents know what cultural stereotypes are, and do not need further development of this competence, but rather focus on their impact on cooperation between employees.



**Figure 5. Communication**

Source: own elaboration.

Figure 4 focused on competences that can support to improve multicultural communication. Most of the answers (92%) were perceived as answers ‘very important’ and ‘important’ in the entire survey, which allows to conclude that communication was recognized as the most important factor that can improve cooperation between employees and

minimize risks in multicultural organisations. Decisively the employees from lower level stated that the most important is the competence ‘to analyse differences in meanings of one word or sign in different languages’. It is necessary, because the same word can have different meaning in different languages. On the other hand, managerial staff agreed that, apart from differentiating the meaning of words or signs, it is also supportive in work to recognise different communication styles as not all the people have the same style, the same level of speed and the same level of effectiveness.

The responses should not be surprising as in the literature many publications (Ochieng & Price, 2010; Otter & Emmitt, 2008) indicate the importance of the communication in multicultural environments. What can be worrying, Polish respondents did not take into account the importance of differentiating communication styles, which can be crucial in everyday contacts of multicultural teams (Gilley, Gilley & McMillan, 2009).



**Figure 6. Teamwork and social integration**

Source: own elaboration.

In Figure 6, the respondents were asked about competences that may improve teamwork and social integration in the multicultural organisation. In the opinion of the respondents – both managerial staff and employees from lower level in multicultural organisation, the crucial competence was ‘to identify the effective ways how to solve problems in multicultural organisation’. Solving problems in cultural diversity of the organisation is indeed one of the crucial elements to ensure effectiveness in works (Velten & Lashley, 2018).

The interviewees (especially employees from lower level) identified the competence ‘to define the term *adaptation* as a key element to work effectively in a multi-cultural organisation’ as the least important competence. Similarly to the responses of the respondents in previous Parts, they did not focus on theory, but practical aspects.

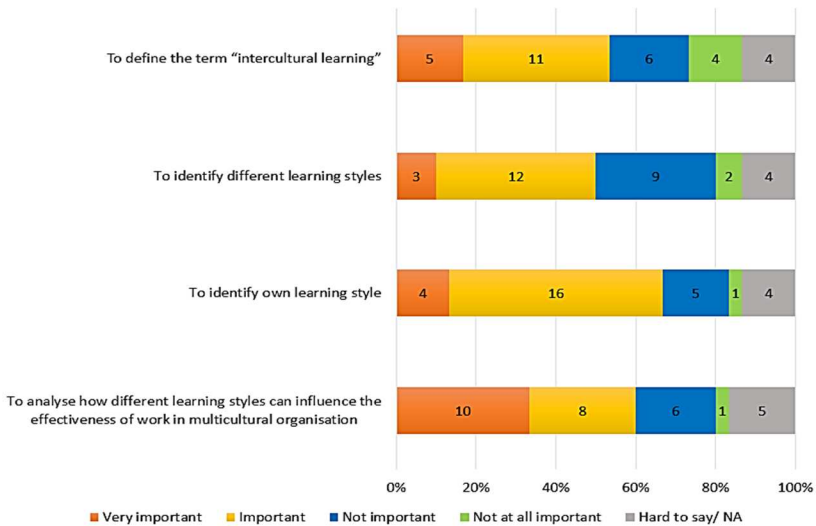
In Figure 7, the interviewees had to indicate, which competences, related to leadership and hierarchy, influence the quality of work in the multicultural organisation. Almost all of the competences obtained more than 80% of ‘very important’ and ‘important’ answers. Only the first competence (‘to analyse how to introduce changes in the organisation’) obtained 27% of ‘very important’ and 47% ‘important’ answers and this answer was mainly given by the managerial staff.

According to the respondents, the least important competence was ‘to analyse how to introduce changes in the organisation’. 13% of them indicated this competence

as ‘not important’, and 10% of them (only employees from lower level) as ‘unnecessary’. It is surprising, because the management change is one of the most important factors in the organisation (Kotter, 2011).



**Figure 7. Leadership and hierarchy**  
Source: own elaboration.

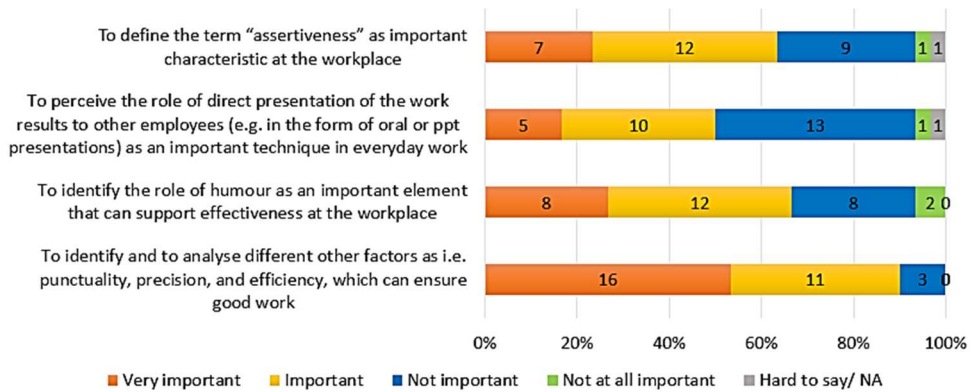


**Figure 8. Learning styles**  
Source: own elaboration.

Figure 8 aimed at examining, which competences are important to better recognise learning styles. The most important competence turned out to be ‘to analyse how different learning styles can influence the effectiveness of work in multicultural organisations’ with the score of 33% of ‘very important’ and 27% of ‘important’ answers.

As the least important competence – 30% ‘not important’ was indicated ‘to identify different learning styles’. Here, it was observed that mainly employees from lower level decided in this way. It clearly shows that the respondents highlighted their own learning

style, not the styles of the co-employees. It can cause the problem related to the completion of tasks in the time given, to keeping deadlines and also to the achievement of the high quality of the results (La Fever, 2010).



**Figure 9. Qualities in the working place**

Source: own elaboration.

Figure 9 focused on the competences that may improve the quality of work in the working place in multicultural organisations. The most valuable competences was ‘to identify and to analyse different other factors as i.e. punctuality, precision, and efficiency, which can ensure good work’ with the score of 53% as ‘very important’ and 37% as ‘important’. This competence was important both managerial staff and employees from lower level in a multicultural organisation.

It can show that the respondents take into account such elements like punctuality, precision or efficiency. On the other hand. The interviewees indicated the competence ‘to perceive the role of direct presentation of the work results to other employees (e.g. in the form of oral or ppt presentations) as an important technique in everyday work’ as the least important competence, which can mean that they prefer direct contacts between people, not concentrating on technical issues of working in multicultural organisation.

### CONCLUSIONS

The need for intercultural competence has become a necessity for the organisations. In the midst of unprecedented demographic changes most countries now have residents, workers and citizens originating from countries all over the world, and to all intents and purposes are multicultural, some to a greater extent than others, but becoming increasingly so. The need to understand the role of culture in intercultural interaction and to be aware of cultural risks in the organisation is growing, and in light of globalisation intercultural competence becomes even more crucial. There is increasing awareness, if not knowledge of cultural difference among staff in different organisations. The effect of the lack of competence can be far reaching. The relationships between employer / employee or employee / employee are affected when there is misunderstanding or lack of

knowledge about each other's expectations. There is need to understand why some people from different cultures are reticent and will not ask for help or participate in discussions that involve being critical of employers or employees in the institution, even if it is constructive. A lack in understanding these differences is often one of the major intercultural problems that could arise in business negotiations.

This study aimed at identifying competences, which seem to be crucial in order to work more effectively in the multicultural organisations and to get familiar with the diversity coming from the staff representing different cultures. Based on conducted study we have found out that for the participants of the interviews it is very important to know different aspects related to culture, which will contribute to the effectiveness of work. Taking into account different types of the respondents, it can be stated that managerial staff paid more attention to managerial competences and theoretical aspects. As opposite, employees from lower level focused mainly on competences, which can be used in direct contacts with the colleagues from different cultures. They were not interested in acquiring competences, which are theoretical, but these ones, which can be used in everyday life in working conditions.

The article is of not only theoretical, but mainly applicative character, because based on the results it is possible to develop a training for the intercultural staff, which will support them in coping in multicultural environment. However, the study was limited to multicultural organisations from Poland, so in such a way they should not be generalised.

The next step of the research should be to compare the results with the results from different countries in order to see similarities and differences.

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### Appendix 1

<b>Module 1:</b>	
<b>CROSS CULTURAL AWARENESS</b>	
<i>Which competences are important to be culturally aware in multicultural organisation?</i>	
1	To define the concepts: “culture”, “cultural awareness”, “culture sensitivity” and “culture shock”
2	To recognise the most popular cultures occurring in Europe
3	To analyse the main differences between own and other cultures
4	To distinguish between cultural differences of the society and differences of the individuals (case studies)
5	To get familiar with interesting models of culture, i.e. the Iceberg Model of Culture, Hofstede’s Cultural Dimensions Theory, Milton Bennett’s Cultural Sensitivity Model
<b>Module 2:</b>	
<b>UNDERSTANDING DIFFERENT CULTURES</b>	
<i>Which competences are important to understand better different cultures?</i>	
1	To understand the role of tolerance between people of different cultures
2	To understand why people from different cultures can behave differently
3	To identify nuances in cultural norms and values
4	To analyse the key cultural drivers and attitudes (i.e. time, space, authority, risk, tasks and relationships)
<b>Module 3:</b>	
<b>STEREOTYPES</b>	
<i>Which competences are supportive to understand and break cultural stereotypes?</i>	
1	To define the term “cultural stereotypes”
2	To identify the main reasons of the cultural stereotypes
3	To analyse the influence of cultural stereotypes on people working in multicultural organisation and the effectiveness of their work
4	To identify possible cultural biases, prejudices and beliefs



<b>Module 4:</b>	
<b>COMMUNICATION</b>	
<i>Which competences can help to improve multicultural communication?</i>	
1	To recognise different communication styles
2	To identify own style of communication
3	To analyse differences in meanings of one word or sign in different languages
<b>Module 5:</b>	
<b>TEAMWORK AND SOCIAL INTEGRATION</b>	
<i>Which competences may improve teamwork and social integration in multicultural organisation?</i>	
1	To define the term “adaptation” as a key element to work effectively in a multi-cultural organisation
2	To identify changes that are needed in multi-cultural teams (i.e. related to the management, responsibilities of employees, organisation of works)
3	To analyse the role of the emotions in multicultural team
4	To identify the effective ways how to solve problems in multicultural organisation
<b>Module 6:</b>	
<b>LEADERSHIP AND HIERARCHY</b>	
<i>Which competences are related to leadership and hierarchy that influence the quality of work in multicultural organisation?</i>	
1	To analyse how to introduce changes in the organisation
2	To analyse how to divide responsibilities in the organisation
3	To identify and to analyse artefacts in the multicultural organisation (i.e. behaviours of the employees towards new employees; meetings of employees outside the company aimed at their better integration; other ceremonies and rituals in the organisation)
4	To identify and to analyse basic norms and values in the organisation
5	To analyse different cultures in the organisation, i.e. masculinity or femininity culture
6	To analyse the relations between people in the multicultural organisation
<b>Module 7:</b>	
<b>LEARNING STYLES</b>	
<i>Which competences are important to know better learning styles?</i>	
1	To define the term “intercultural learning”
2	To identify different learning styles
3	To identify own learning style
4	To analyse how different learning styles can influence the effectiveness of work in multicultural organisation

<b>Module 8:</b>	
<b>QUALITIES IN THE WORKING PLACE</b>	
<i>Which competences may improve the quality of work in the working place in multicultural organisation?</i>	
1	To define the term "assertiveness" as important characteristic at the workplace
2	To perceive the role of direct presentation of the work results to other employees (e.g. in the form of oral or ppt presentations) as an important technique in everyday work
3	To identify the role of humour as an important element that can support effectiveness at the workplace
4	To identify and to analyse different other factors as i.e. punctuality, precision, and efficiency, which can ensure good work


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