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INDUSTRIAL POLICY: WHO WINS, WHO LOSES

INTRODUCTION

Proponents of national industrial policy pursue noble goals. They want to accelerate the progress of "winning" industries, rescue from oblivion industries that are deserving of winner status but are being denied this rightful place, and help Americans who would be hurt by the demise of declining firms. Industrial policy is to help both winners and losers. Everyone will gain.

At least two important assumptions underlie the notion that government action should and can achieve these seemingly worthy goals. First, businessmen and consumers, left to their own devices, are said to be prone to err and lack vision. Second, the best and the brightest, assembled in the halls of government, can see the future more clearly and objectively, and plan accordingly.

These assumptions are central to the case for industrial policy enunciated by Ira C. Magaziner, Robert B. Reich,[1] and other writers. They look at Japan, Germany, and elsewhere, and find economic growth there much faster than in the United States. They argue that this superior performance is explained by certain government policies.

These writers employ the reasoning--called post hoc ergo propter hoc--that if one event follows another, the first must have caused the second. The most common arguments for industrial policy are a classic case of the post hoc fallacy. Proponents of

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1 Ira C. Magaziner, and Robert B. Reich, Minding America's Business (New York: Harcourt, Brace, Jovanovich, Publishers, 1982).

industrial policy argue that Japan has prospered since it instituted the policy, so that policy must be responsible. The U.S. should emulate Japan if it is to prosper. They could just as easily have observed that the hound dog bays at the moon and the moon rises--so the dog must have propelled the moon.

If the connection between industrial policy and economic performance is as spurious as that between the dog and the moon, the policy may turn some winners into losers and some losers into long-term losers. The directing agency that pushes winners forward and softens the punishment of losers may not be blessed with farsightedness but cursed with myopia.

There is increasing evidence to support this. In an attempt to present their case fairly and honestly, Magaziner and Reich cite some of the failings of the Ministry of International Trade and Industry (MITI) in Japan. They note that MITI supported steel, an industry that later encountered trouble, and opposed a proposal by the Japanese automobile industry that it expand its export market. MITI is run by human beings and they can make mistakes. Katsuro Sakoh, of the Council for a Competitive Economy, has also examined aid given by the Japanese government to certain industries and concludes this aid cannot account for Japanese success.[2] Rather, he notes, policies of lower taxation, low government spending, and strong private saving are far more important in explaining the Japanese success. But these policies, together with a more accommodating anti-trust policy and good labor relations, apply to all industries. They are not used to favor some industries and constrain others. In this generally freer environment--and perhaps because of it--Japan has prospered.

A second reason for doubting the wisdom of relying on those who consider themselves all-knowing comes from the experience of the last three decades. U.S. economic growth lagged behind that of Japan and most of the countries of Western Europe during the 1960s and 1970s. But the growth rates of almost all the countries held up as exemplars of industrial policy actually fell during the 1970s. What could account for this widespread decline? The 1970s were characterized, both in the U.S. and abroad, by increasing government efforts to do just what industrial policy proponents now suggest: employ government planning to guide the economy to overcome its bad features and promote its good features. But the more governments tried to help winners and protect losers, the worse has been the record of growth: both winners and losers have suffered.

Theory and empirical evidence deny the efficacy of extensive efforts by government to direct economic activity. To expand

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2 Katsuro Sakoh, "Industrial Policy: The Super Myth of Japan's Super Success," Heritage Foundation Asian Studies Center Backgrounder No. 3, July 13, 1983.

government control over the economy, when there is so much evidence that it is counterproductive, is to invite even more trouble. The supporters of industrial policy conveniently ignore the results of policies during the 1970s; they concentrate only on snapshot comparisons between countries.

There is a third case forewarning of the results of industrial policy. For almost fifty years government has actively directed the American agricultural economy, selecting some products and producers on whom to bestow benefits, others to whom less attention will be paid, and still others to be penalized. But despite efforts by well-intentioned public servants, "It's hard to find anyone who actually likes the U.S. farm program."[3] And it is no wonder. In its efforts to help winners and losers, agricultural policy has made almost everyone a loser. The few winners appear to be (1) those who administer the programs, (2) owners of some farm land, and (3) large, successful farmers who would have been big winners under almost any rules devised. Similar results obtain in almost every country with a significant agricultural policy. And the more significant the policy, the more damaging the results.

All in all, there is a good cause to doubt that national industrial policy will deliver the advertised results. The Japanese experience with MITI, the experience of most industrial countries during the 1970s, and the experience of agricultural policies worldwide, are all discouraging portents for its success.

WINNERS AND LOSERS IN A FREE MARKET ECONOMY

In every society there always will be winners and losers. In a society that depends for sustenance on hunting, greater rewards will go to those who are swiftest and have the keenest senses. Other societies shower benefits on one who can toss a round ball through a hoop ten feet from the floor. Those who are not tall or well coordinated gain fewer or different rewards.

In a free market, "winners" will be those who best serve their fellow men, as Adam Smith astutely observed over two hundred years ago.[4] Those who can best determine what others want, arrange to provide them with those goods, using the least amount of available resources, and decide how to distribute and tell others about these goods, will be winners. They make others happy; they make the most of limited assets; and they do this in an atmosphere without coercion.

Losers do the opposite. They produce goods and services for which people do not clamor. Or they have learned to make things

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3 Susan Lee, "Private Income Buffer: Farmers Have Options," <u>Wall Street Journal</u>, September 8, 1983, p. 28.

4 Adam Smith, <u>An Inquiry into the Nature and Causes of the Wealth of Nations</u> (New York: The Modern Library, 1937).

that people want, but in making them use inordinate amounts of land, labor, or capital. Their products are expensive, and consumers are not willing to pay the price.

Some individuals may prosper by providing their fellow citizens with the goods they want, but fads, customs, or technology may work against them. Those who provide the chemicals for ladies' permanent waves will be winners until a new fad decrees that waves are out and straight is beautiful. Technology has removed the village smithy from his winning position under the spreading chestnut tree and replaced him with the tractor mechanic. But just as winners do not have tenure in their position, neither do losers. Opportunity always exists for losers to elevate their position. All they must do is serve their fellows effectively and efficiently. There are thousands of things that people want and there are millions of opportunities to become winners.

The consequences of the selection of winners and losers have been discussed in detail in books on economics ever since Adam Smith's Wealth of Nations. They describe a complex but ordered process. Producers are encouraged by profit to provide goods that people want most and to do this with the least cost. Individuals gravitate to those jobs where they can maximize the pleasure (income and otherwise) they receive from work while ensuring that consumers get the greatest pleasure from what they produce. Goods go to those who have done most to make others happy, and are willing to give up most to get them. As Milton Friedman notes, all this is accomplished because of another priceless benefit: the freedom pervading the system, in that people can consume what they prefer and workers can take jobs they find most appealing. No one is restricted from these opportunities by law.

This does not mean that everyone will get everything he wants. Nor will everyone work where he wants, or at the compensation he thinks appropriate. Rather, winners and losers will be determined by their inherent abilities, the peculiar desires of individuals in society, and how well these two mesh.

Not all is perfect in this relatively happy state, point out proponents of industrial policy. Every society and every individual, of course, falls short of perfection--and rationally so. The cost of improvements beyond some point exceeds the gains from the improvements. Each individual could make his life, his business, or his athletic skills better. But to say that something should be changed because it is not perfect is a non sequitur. To make a rational, rather than emotional, argument, advocates for industrial policy must demonstrate that their plan is less imperfect.

WINNERS AND LOSERS UNDER AN INDUSTRIAL POLICY

Industrial policy necessarily must produce a different array of winners and losers from that in a market system. But predicting the new winners and losers in detail is not a strong point of economists.

The complex forces of demand, supply, self-interest, and cost, which operate so naturally in economic markets, also operate when decisions are made politically. They enable prediction what decisions will be made and what the results will be. Two general theories, one dealing with public choice and the other dealing with rent seeking, incorporate these economic forces to help assess who will win and who will lose from industrial policy.

Public Choice

The theory of public choice provides an explanation for many government actions and their economic consequences. It helps evaluate the notion that government serves the people and does what the majority wants. Industrial policy is built on this foundation, and it is shaky.

Consider first the question of serving the people. What this has to mean, in practice, is serving some of the people at the expense of others. Someone must decide who is worthy, who is not, and who will be forced to give the assistance.

There are important differences between this process and the free market. First, in the market the decision as to who will win is made voluntarily by all who choose to buy the product made by the successful individual. Second, all parties gain from the transaction. The producer improves his lot and the consumer buys those things he prefers above all others available. Even in this positive-sum game, of course, some are not happy: those who cannot produce as efficiently as those who make a sale, and those who want the good but not badly enough to pay what it costs. Still, the gains necessarily exceed these minor losses, and society moves to a higher level of output.

Gary Becker has pointed out that political decisions on economic matters differ from market decisions, as do the results.[5] For one thing the politician, who decides for society, is elected to make decisions for a given period of time--two years, four years, or six years. If voters become disenchanted with his decisions, they are stuck with him until his term expires. If a private firm disenchants its customers, however, it loses them immediately.

Becker also notes that voters may like some decisions of the politician and detest others, but the politician will decide on all. It is as though a consumer appointed Sears to be his only supplier of all goods Sears sells. In free markets, consumers

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[5] Gary Becker, "Competition and Democracy," Journal of Law and Economics, October 1958, pp. 105-109.

buy some goods from Sears, some from Penney's, and some from other shops. In government, it is all or nothing. This can be a problem with industrial policy. A voter may sympathize with the need to support one industry, but see little reason for beneficence to others. Industrial policy, however, decrees that all those selected will benefit.

A third feature characterizes political decisions. Consumers tend to be "rationally ignorant" about almost all government decisions. Because the elected official cannot be replaced soon, and bureaucrats almost never, and because each of the many issues before the legislature will have only a limited effect on each citizen, the prospective gain to the average individual citizen from studying and trying to change any bill before Congress or the city council is little or nothing. There are hundreds of other personal and economic matters on which he can spend his time more profitably. It is likely to be more important to most voters to figure out when and where to buy new tires than to study the nation's policy on dairy products.

A proposal to favor an industry, on the other hand, will be of considerable interest to individuals who own, supply, or work for firms in that industry. Each has much to gain or lose. With a small group intensely interested in support for an industry and a large group of citizens who once were unconcerned with the issue, it is easy to predict that special interests will determine what gets done. But which special interests prevail depends on a second broad theory--that dealing with rent seeking.

Rent Seeking

Individuals and firms who would like to become winners can do so in a free market by building the better mousetrap. If producers earn more money in this work than in any other, the excess amount is what economists call rent. Producers receive this gain because they do something better than anyone else, and society, unknowingly but voluntarily, rewards them. Stephen Jobs earned rent by inventing a better computer, called an Apple. Frank Sinatra earns rent because he built a better singing style. Rent performs a valuable function--it attracts people into those jobs that bring joy to others.

There is another way a producer can earn more money, or rent. He can do something better than anyone else because everyone else is forbidden from doing what he does, or because he is given a subsidy and his competitors are not. In these cases the excess earnings, or rents, serve the producer but not society--which has to pay more for the products it receives.

There is a strong incentive in a free market for a producer to determine what consumers want and to produce it efficiently. Natural market forces lead him to do good for others. But there is also a strong incentive for the producer to find a way to have his competitors eliminated, or at least limited in their ability to compete, or to arrange for his output to be subsidized. Only government has the legal power to outlaw or reduce the output of competitors, and government is by far the largest and most easily tapped source of subsidies. What the producer needs is a rationale to make these destructive activities appear desirable.

Industrial policy is the newest in a long list of such excuses for government action. In the past, government has restricted or outlawed competitors in the name of agricultural self-sufficiency, energy independence, labor policy, banking stability, airline safety, environmental purity, interstate commerce, and much, much more. It has subsidized producers to promote such objects as national defense, educational standards, more small businesses, and better waste treatment. This is not to say that such goods, services, and conditions are not desirable, but to say that these producers have been helped or subsidized at the expense of other, usually much more productive, firms.

The same desire to become a winner and enjoy higher income, which attracts individuals to produce valuable goods in a free market, can be counted on to inspire them to try to have their competitors hamstrung and subsidies paid to themselves, under the guise of an industrial policy. This means that competitors who would be successful in a free market will find themselves constrained, while those who believe they deserve greater success than the free market provides, or who are in danger of failing, will find the going easy.

Worse still, firms would soon realize that government might not select them unless their "social worthiness" were brought to the attention of the selectors. These firms would resort to lobbyists and public relations experts to plead their case, a costly operation.

There is another lobbying cost in choosing winners and losers under an industrial policy, rather than by the free market. Some competitors adversely affected by these new government policies would lobby to prevent the new laws. Resources thus are spent not in producing new goods but in promoting and fighting new legislation.

Virginia Polytechnic Institute economist Gordon Tullock asks how activities would change if laws against stealing were relaxed.[6] People would, he explains, spend more time planning how to steal from others and more time protecting possessions. The more one group spent to find ways to take from others, the more others would spend to find ways to protect themselves. Something akin to this occurs when government is given power to take from some

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6 Gordon Tullock, "The Welfare Costs of Tariffs, Monopolies, and Theft," Western Economic Journal, June 1967, pp. 224-232.

and to give to others in the name of some national goal such as industrial policy.

If industrial policy were to be adopted, then, the outcome is predictable. Small groups of producers would find that they could reap large gains by spreading the burden over a large part of society, so that each person bore only a small share of the cost. It would not pay the loser to object, but it would pay the winner to campaign long and hard for favorable treatment. He would seek rents. And he would spend large amounts of money, and cause consumers to spend even larger amounts, to reap small net gains.

LIKELY WINNERS AND LOSERS

Who will be the winners and losers thanks to an industrial policy? Economists cannot predict exactly, but the general principles give valuable guidance.

1. Firms that would be winners in free markets would probably have smaller winnings, and their output would fall.

   As winners in free markets, the efforts of these firms are most profitably used in producing the goods consumers want. If they divert their resources to campaign for greater protection, they are unlikely to make a net gain. Their rents lie in production, not in restrictions. They may, however, have to devote resources to protect their flanks, since it is easy for government to declare new products *non grata*. Furthermore, taxes would have to be raised to pay the costs of administering an industrial policy and to pay subsidies to other firms. Successful firms are most likely to be taxed. And as less efficient firms are helped to expand their output and to bid away resources from the others, successful firms will find their costs rising. Success, in other words, carries increasing penalties under an industrial policy.

2. Potentially successful firms might have their paths smoothed and become winners, but this would not be certain.

   If they truly are destined for success, firms want the maximum possible freedom. But if industrial policy happens to result in their selection for aid, it will also result in their selection for control.

3. The great middle class of industries, those earning average rates of return, with no particular prospects for becoming winners in a free market, would likely try to become winners with the aid of industrial policy.

   The issue these firms have to resolve is which is the least costly path to success. In February 1979, farmers were faced with just that question. Could they increase their incomes more effectively by driving their tractors back and forth across their fields to cultivate them, or by driving them to Washington, D.C., as a political protest? Many concluded the latter was the road to success and drove to camp sites on the Mall in an effort to force government to select them for winner status, with all the government support that entails.

4. Those industries sorely beset with economic problems would be outstanding candidates for industrial policy aid.

Despite industrial policy's announced goal of helping winners, losers gain the most in turning from the economic market to the political market. They will sacrifice little by diverting their attention from business, and gain much by concentrating their attention on political power, compared with the prospects in the market. They will spend a great deal of time convincing others of their worthiness. And since costs will be spread among all taxpayers or among all consumers of their product, rational ignorance will mitigate or eliminate opposition.

5. Consumers and taxpayers would be consistent losers.

Consumers will finance losers directly and indirectly through taxes and higher prices. They will spend more on the goods government decides should be produced, and so will probably get less of these products while paying more for them. Automobiles are an example. Consumers are paying higher prices, and are getting more American-made cars. But fewer cars are being sold in total, compared with the level in a free market, since Japanese exports have been restricted. The resulting higher costs assure a lower volume of sales than in a free market. Industrial policy, for all its alleged good intentions, is a negative-sum game and the final result is that consumers have less to consume.

6. One group of certain winners would be the government employees administering the program.

By definition, government workers accept that employment because it pays more than the best alternative. They are assured of tenure as long as the problem persists. There are always industries that look promising and deserving of aid, and there will always be losing industries that can be given succor to ease their condition.

THE EMPIRICAL EVIDENCE

These predictions are harsh, and differ from those offered by supporters of industrial policy. Proponents cite more successful economies to support their proposal, yet weaknesses with their examples and line of reasoning have been noted. Meanwhile, there have been several decades of government efforts to improve the economy that can be examined.

Throughout the 1930s government did much to try to shorten the depression. Yet it was the deepest and longest depression in U.S. history. After sharply reducing the money supply, government adopted policy after policy to cure the depression by limiting any price decline. All of this helped prolong the depression. It is generally conceded that only wartime production brought recovery. The National Industrial Recovery Act and its offspring expanded government, taxes, and bureaucracy, but not output.

Agriculture policy provides another lesson. Although an industry may be helped by limiting its competitors, this does not mean producers of the good will gain. Consider tobacco. Imports of tobacco have been restricted so that the income of domestic growers will rise. Further, to keep domestic output under control, acreage devoted to tobacco has been limited through acreage allotment programs. In effect, Congress made tobacco land scarce, causing the price of tobacco allotments to appreciate. The owners of that limited asset, land, were able to reap all of the gains. Tobacco farmers as such do not gain. The benefits of industrial policy will tend to flow to owners of the artificially limited resource, not necessarily to the groups targeted for aid, such as workers.

For over thirty years, the Civil Aeronautics Board took a similar approach by limiting the entry of new airlines. This should have increased profits for existing lines. Unions representing employees, however, had monopoly power, so that it was the unions who realized a large part of the gains.

Japan is always cited as an example for America to follow, but Britain is a country with a political system more like the U.S. Because the British government has assumed more responsibility for economic affairs than has been the case in America, the U.S. may learn from Britain how politicians and government employees respond to requests for assistance when government has the power to grant such requests. The steel industry is just one example. It was losing money and in danger of expiring, causing losses to owners, workers, and suppliers. The government decided that it would benefit the nation if the industry were maintained and so it was nationalized after the World War II. But its losses have increased, and now amount to about $2 million a day. Automobile manufacturing, coal mining, shipbuilding, railroads, and electricity are also industries that Britain's government has selected for aid, and all continue to lose money. Proponents of industrial policy have provided no reason to believe the U.S. experience would be different.

CONCLUSION

Theory and empirical evidence show that industrial policy is an idea whose time came and went many years ago. It is based on the spurious contention that government knows better than individuals what should be produced and who should produce it. If Congress were so unwise as to enact such a policy, experience shows what to expect. Those few who expected to be winners under industrial policy would push it actively, since each would enjoy large individual gains. The majority of the population would remain rationally ignorant of the matter. It would create new winners and new losers, not more winners and fewer losers. The winners would win not by helping others but at the expense of others. And losers would lose because they concentrated on increasing output. A society that chose winners and losers on these grounds would itself become a loser.

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