The Heritage Foundation Backgrounder

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THE FAULTY LOGIC OF INDUSTRIAL POLICY

INTRODUCTION

Intellectual support for the notion of an industrial policy is unraveling. Several decades of increasing political control over the economy have left a record that only the most doctrinaire interventionists attempt to defend. And the growing field in economics known as public choice has developed a formidable set of models indicating that the failure of intervention is not an aberration, but a logical consequence of political decision-making.

The response by proponents of a national industrial policy--next time we will do it right--is a triumph of hope over experience, and over logic as well. Those whose political careers, business interests, and academic efforts are served by active government involvement in the economy have cause for concern over the faltering of scholarly support. Without the cover of intellectual respectability, their arguments become transparent and vulnerable.

It is not surprising that an anxious market is demanding fresh arguments for big government from academically respected sources. This demand is now being met with a supply of rhetoric and recommendations calling for a national industrial policy. But recognizing that a direct call for more government is not likely to be a successful approach, the advocates of an industrial policy are predictably vague about the specifics of their recommendations. Generally, they draw attention to a host of problems that currently plague the U.S. economy, with the clear suggestion that the source of these problems is excessive reliance on the private market.

Recommendations for action typically take the form of vague platitudes, such as creating a "productive partnership" between government and business, or using government intervention not to supplant market forces but rather to "make them more effective."

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And the justification for specific measures inevitably includes the assumption that government operates in an impartial, far-sighted way and will always achieve its supposedly wise goals. At a different level, the justification for an industrial policy rests on the argument that the approach has worked economic wonders in other countries, most notably Japan, and so presumably will work here as well.

Such arguments seem to have their maximum impact when they are packaged in scholarly prose emanating from academically renowned institutions.

There is no shortage of books and articles fitting this description. And while the industrial policy advocates do present similar recommendations, it is possible to discern a number of schools of thought--or at least different degrees of emphasis on policies. Lester Thurow of MIT, for instance, strongly recommends federal government involvement in basic investment decisions in order to facilitate the transition from sunset to sunrise industries.[1] Thurow's advocacy of public investment banking puts him in step with New York investment banker Felix Rohatyn, who urges a new Reconstruction Finance Corporation, a key part of the New Deal. The purpose of the new RFC would be to allocate capital in accordance with the dictates of a council of labor, business and government leaders. Professors Barry Bluestone of Boston College and Bennett Harrison of MIT, on the other hand, see government bailouts, nationalization of selected industries, and more political control over the hiring and promotion decisions of private firms as the central features of a national industrial policy.[2]

These and other academics play varied, and sometimes even conflicting roles in the industrial policy campaign. It is Harvard's Robert Reich, however, who has attracted most attention. Reich's book, The Next American Frontier,[3] has received an enthusiastic reception in liberal quarters, because of the intellectual horsepower it seems to provide to the case for a strong and active government. "Bob Reich is brilliant...," gushed New York Magazine. "One of the most important works of the decade," said Walter Mondale. "The historical sweep of the analysis and the intellectual rigor of the diagnosis are truly remarkable." And Senator Gary Hart believes strongly in "Mr. Reich's admonition that we must adapt and his penetrating insights on how to adapt should be heeded. Nothing less than America's economic future is at stake."

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1 Lester C. Thurow, The Zero Sum Society: Distribution and the Possibilities for Economic Change (New York: Penguin Books, 1981), pp. 203-204.

3 Barry Bluestone and Bennett Harrison, The Deindustrialization of America: Plant Closings, Community Abandonment, and the Dismantling of Basic Industries (New York: Basic Books, 1982).

3 Robert B. Reich, The Next American Frontier (New York: Times Book, 1983). The following two sections of this paper are based on Dwight R. Lee, "Robert Reich's Industrial Fantasies," Journal of Contemporary Studies, Summer 1983.

Such lavish praise has little to do, of course, with the merit of the analysis. That those who continue to put their trust in government solutions have latched onto Reich with such zeal indicates just how desperate they are for intellectual support and how weak this support really is. Reich's book is almost devoid of new arguments in support of political guidance of economy and completely devoid of arguments that make sense.

THE ALLEGED INFLEXIBILITY OF AMERICAN BUSINESS

The U.S. economy is obviously suffering from problems, and Reich lays them out clearly. The rate of productivity has declined over the last two decades, for instance, and basic industries such as steel, automobile, and rubber are being battered by foreign competition. In describing such factors, Reich attempts to maintain credibility by acknowledging, although cautiously, that government has been responsible for some of industry's difficulties. But he quickly exonerates many of the government policies that have been widely blamed for recent economic problems. We are "informed," for example, that government regulations have not retarded productivity and that budget deficits cannot be blamed for discouraging capital formation. The root of the problem, apparently, is an inflexible business community that refuses to adapt to the reality of "global change."

Paper Entrepreneurialism

At the heart of Reich's thesis is the idea that the U.S. economy is falling behind the rest of the world because business is still relying on outmoded management techniques. The time and motion approach to assembly line production, he says, was well suited to the standardized high-volume production processes upon which an industrially based economy depends. But as international trade has expanded, and the world has become one big market, the U.S. is being overtaken in basic industrial production by less developed countries with easy access to high-volume production techniques and cheap labor. America's comparative advantage, he believes now lies in precision products, custom products, and those products that depend on rapidly changing technologies. Their production is not suited to standardized high-volume techniques, says Reich, but instead requires what he calls "flexible-system" production.[4] Unfortunately, American businessmen are tied

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[4] Reich provides page after page of detailed description and history of the standardized, high volume production management technique, but when he comes to the flexible-system approach, the approach upon which our economic future supposedly depends, he is distressingly vague. We are told that the flexible-system approach is a highly integrated system that merges traditionally separate business functions into a team that can respond quickly to new opportunities. This certainly sounds good, but there is nothing that resembles operational information here. Apparently the flexible-system production approach is simply too flexible to hold still for easy description.

to an old management approach and are unwilling to adapt to the flexible-system technique. Rather than adapt, U.S. businessmen have resorted to nonproductive, short-sighted measures that allow them to maintain their traditional ways.

Reich refers to this short-sighted activity as "paper entrepreneurialism." The essence of this phenomenon is the use of potentially productive resources, not to create new wealth, but to realize short-term profits by capturing the existing wealth of others. The increased use of conglomerate mergers, creative accounting, litigation, corporate takeovers, management shifting, and tax avoidance schemes are given as examples of paper entrepreneurialism. And the "atmosphere of insecurity and impermanence" resulting from all this unproductive predatory activity, in Reich's words, "bred a selfish attitude among directors, managers, and employees...."[5]

Employee Training

Reich is also concerned that American workers are not being properly trained for the new economic realities. He sees a need for public policies that will assist workers to develop the skills required in a flexible-system production environment. Existing policies are retarding the development of these skills and, according to Reich, America's workers are headed for "dead-end labor." Reich's underlying explanation for dead-end labor is the same as that for other economic problems: infatuation with standardized, high-volume production techniques. The effectiveness of government services, which Reich sees as an important vehicle for training, is limited by standardized procedures that fail to recognize the circumstances of individual recipients. Yet business training is oriented toward the narrow labor skills appropriate to mass production techniques, and the results are inadequate, if not counterproductive. Even the problems of the public schools are traced back to the fixation with mass production. The schools are interested in processing large numbers of students, says Reich, and standardized procedures and programs facilitate this objective. An educational environment that resembles the assembly line unfortunately fails to develop and nourish the creativity and adaptability that workers will need in an environment of flexible-system production.

THE WEAKNESS OF REICH'S ANALYSIS

What does Reich recommend for overcoming these problems? He does not recommend more government directly. Rather, "the government's role in industry [should] become not so much more extensive as more open, more explicit, and more strategic."[6] For government

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5 Reich, op. cit., p. 166.
6 Ibid, p. 14.

to properly assume this role, he notes, will require a reassessment of the distinction between the private and public sectors. In reality, Reich argues, a useful distinction between the two no longer exists. There is, in fact, a partnership between government and business, and for this partnership to be effective, it is necessary to accept government's ineluctable role in the economy.

One searches Reich's book in vain, however, for specifics on how political incentives are to be restructured to motivate appropriate responses from politicians and bureaucrats to the economic challenges he delineates. There are calls for a new consensus for political action, but no plausible operational details. Apparently, once business embraces government as an equal partner and develops a social consensus, the foundation will be in place for the economic renaissance. This approach has worked wonders, the reader is told, for Japan, West Germany, and to a lesser extent, France.

It is interesting to note that, although Reich is praised for laying the groundwork for a new industrial policy, he actually is reluctant to make an outright call for more government economic planning and intervention. Indeed, he says explicitly that the answer to U.S. problems is not national planning, with bureaucrats channeling capital to those industries identified as winners and away from others designated as losers. Instead, Reich proposes a government that "seeks to promote market forces rather than supplant them...." Throughout his book, nonetheless, the call for more government responsibility is clear. And it is this call, sounded in the guise of scholarly analysis, that appeals so strongly to politicians seeking a rationale for variations on outdated interventionist policies.

Innovation

After penetrating Reich's generalities and platitudes, one finds little of substance, little that can stand up to critical examination, and much that borders on the preposterous.

The argument that U.S. economic problems are rooted in the reluctance of businessmen to adapt because they are hopelessly wedded to outmoded techniques seems to be original with Reich. It is also blatantly wrong. Consider Reich's statement: "American industry has a tradition of marginal, incremental change--like the annual alterations in automobile styling--that maintains high-volume production of essentially the same goods. American managers and investors have generally found wholly new products or processes simply too risky."[7] Obviously most changes are incremental. But to claim that fearful avoidance of significant change best characterizes U.S. business is to completely ignore American economic history. The light bulb, the cotton gin, refined petroleum products, the Polaroid camera, supermarkets,

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[7] Ibid, p. 137.

fast food franchises, Xerox, the telephone, transistors and electronic chips, and fast freezing are but a few revolutionary innovations that were developed and marketed by American entrepreneurs.

Throughout U.S. history, the free market has been an enormous force for radical economic change and adaptation. Indeed, one of the most common complaints against the market economy has been that it subjects people to too much change. Yet Reich asserts that "America [has] lacked any mechanism to accelerate economic change...."[8] The mechanism Reich advocates--government "promotion" of market forces--certainly does not have a very good track record. Reich seems to understand the reasons for this when he points out that, "America's old industries and their workers carry far more political power than emerging...industries."[9] No matter how noble the objectives, an increase in the responsibility of government for economic decisions will result in an increase in the political power of the groups organized around the dominant interests (the owners and workers in existing industries) relative to those who are less organized (the innovators and potential employees of emerging businesses and the consuming public). It is clear from the historical record that political power of this nature has been used to stifle competition and retard economic change.

The innovations and economic change that would be favored if government became more involved in economic decision making are not likely to improve the standard of living, even by the standards defined roughly by Reich.[10] Projects that utilize high technology or allow the U.S. to outperform other countries in highly visible ways--yet which private investors are reluctant to finance--are very appealing to a political agency charged with improving economic performance and "accelerating economic change." Nuclear power plants, which became commercially viable only because of generous government backing, and the supersonic jet transport, which almost became another black hole for U.S. taxpayers' money, are typical of the projects likely under an industrial policy.[11] Industries that innovate and utilize the latest technology to respond to market competition, on the other hand, grow rapidly without political assistance. Political direction of the economy would prop up socially wasteful business ventures, not save socially desirable ones.

Reich is correct in much of his criticism of paper entrepreneurialism. Increasingly, American businessmen have devoted

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8 Ibid, p. 11.

9 Ibid, p. 194.

10 Ibid, p. 271.

11 Bruce Bartlett cites the examples of nuclear power and the SST in his perceptive article, "The Old Politics of a New Industrial Policy," in The Wall Street Journal, April 19, 1983, p. 34.

their talents and resources to activities designed to plunder or protect existing wealth, rather than produce new sources. But it is preposterous to blame this wasteful activity, as Reich does, on the inability of businessmen to adapt to new economic realities. They have adapted quite well. The problem is that the new economic reality most relevant to the bottom line of major industries today has less to do with competition in the market arena than it does with competition in the political arena. The taxing, spending, and regulating activities of the federal government present U.S. business with major threats and opportunities. The ability to understand the intricacies of government actions and rules can do more to enhance the firm's profitability than most far-sighted research programs. The political influence to obtain subsidies or protection can be much more important than meeting foreign competition.

Reich is also on the mark when he charges that it is becoming increasingly hard to distinguish between government and market activity. Rather than using this fact as a justification for blurring the distinction even further, however, Reich should have recognized that the paper entrepreneurialism he finds indefensible is the direct result of government intervention in the economy. It will only be further encouraged by more government involvement. Obviously this is not a position that Reich and his supporters can embrace. But in dismissing the obvious, Reich is left with the absurd argument that the creativity behind paper entrepreneurialism is explained by the inability of American businessmen to adapt.

Education and Training

It is easy to sympathize with Reich's concern over education and training. But it is not so easy to understand how improvements will emerge from Reich's vague generalities. The poor quality of public education needs no elaboration--except to say that standards have declined as federal involvement has increased. Reich is correct that the bureaucratic uniformity characterizing the welfare system has failed to motivate the poor to develop the attitudes and skills necessary for genuine economic progress. This bureaucratic uniformity has been a function of the increased centralization of welfare programs in the federal government. Yet Reich faults the fragmented administration of welfare resulting from the local control that still exists.

Reich acknowledges that U.S. business spends large sums on employee training ($30 billion in 1981, or about one half the total cost of higher education in the U.S.), but he feels that this funding is inadequate. It is motivated by profits, and thus is tainted and results in training that is focused too narrowly. The vague and unhelpful suggestion from Reich is merely that the goal of employee training should be to prepare workers for flexible-system production.

Minimum Wage

While reluctant to advance specific proposals for remedying problems when discussing "inadequate" industry support for employee training, Reich does express concern over what he sees as continuing "political pressure to reduce the minimum wage."[12] Reich goes so far as to suggest that increasing the minimum wage might motivate employers to spend more on training their employees, in order to justify the higher wage. Yet both evidence and common sense strongly suggest that the minimum wage has motivated employers to place the unskilled, when hired at all, in jobs where they have an immediate impact on output but little opportunity to develop skills.

Federal Deficits and Investment

In dismissing the standard explanations for lagging U.S. productivity during the 1970s, Reich argues that government deficits have not been large enough to significantly discourage private investment and retard economic growth. How does Reich know this? Because Japan and West Germany have a larger public debt as a proportion of their national economies than does the U.S. This is true. What Reich conveniently leaves unsaid, however, is that the savings rate, as a percentage of national income, is nearly four times larger in Japan, and three times larger in West Germany, than it is in the U.S. This means that resources for investment are comparatively smaller in the U.S., and therefore federal borrowing has a correspondingly greater negative impact on business investment.

Reich tries to buttress his case that economic growth in the U.S. cannot be blamed on declining private investment by citing figures that indicate little change in U.S. investment, as a percentage of GNP, over the last two decades. Once again Reich is misleading because he fails to include relevant information. The numbers he cites refer to gross investment. But it is net investment (investment over and above depreciation) that adds to the stock of capital and is therefore pertinent to increased productivity. And while the ratio of gross business investment to GNP remained about the same from the late 1960s through the late 1970s, the ratio of net business investment to GNP declined by nearly 40 percent over the same interval.[13] This decline obviously has had a negative impact on U.S. economic productivity.

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12 Reich, op. cit, p. 225.

13 See Martin Feldstein, "Has the Rate of Investment Fallen?" The Review of Economics & Statistics (February 1983), pp. 144-149. This decline in net investment in the absence of a decline in gross investment reflects an increase in the rate of capital depreciation during the 70s. A major reason for the increased depreciation was the rapid increase in the price of energy which reduced the value of energy intensive capital better suited to the era of cheap energy.

The Reich Prescription

When Reich at last gets around to offering specific suggestions--only about 12 pages of his 325 page book--the reader finds a rather standard rendition of the conventional interventionist approach: the use of taxation, spending and the regulatory authority of the federal government to accomplish politically inspired objectives. For instance, "tax incentives could be used to encourage companies to invest in upgrading their work forces and communities,"[14] and "the tax code also might reward companies for remaining in their communities by giving them deductions proportional to their length of stay."[15] The latter suggestion, one should remember, comes from a man who has just spent over 200 pages arguing that hope for America's future lies in flexibility and adaptation. Or consider Reich's suggestion for the federal government to "establish regional banks to provide low-interest long-term loans to industries that agree to restructure themselves to become more competitive."[16] In other words, motivate firms to stand on their own feet by giving them a crutch.

Reich is fully aware of the past and present abuses of government subsidies and tax breaks, many of which he criticizes. And he is aware that political pressure and expediency, rather than economic productivity and efficiency, typically have been the dominant considerations when government assistance is provided. But apparently all this will change if political decisions are made more openly and explicitly. To achieve this fundamental reform: a public board to monitor public programs, "perhaps located in the White House's Office of Management and Budget."[17] The mountain brings forth a mouse.

HASN'T IT WORKED IN JAPAN?

But have not the industrial policies of such countries as Japan and West Germany shown that economic miracles can be orchestrated by detailed government involvement in economic decisions? There is no denying that these countries have been successful, though there has been a recent tendency to exaggerate their success. But most of it can be explained for reasons other than government policy and, indeed, has often occurred in spite of government policy.[18]

Consider, for example, the widely held view that Japanese employers give their workers a high degree of job security. In

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14 Reich, op. cit, p. 240.

15 Ibid, p. 241.

15 Ibid, p. 242.

17 Ibid, p. 245.

18 Katsuro Sakoh, "Industrial Policy: Super Myth of Japan's Super Success," Heritage Foundation Asian Studies Center Backgrounder, July 13, 1983.

fact, this is quite misleading. It is true that employees of major Japanese corporations are not as likely to be laid off as readily as their American counterparts. But it is also true that as much as 35 percent of the Japanese worker's annual salary comes in the form of a year-end bonus, a bonus that is not paid unless the employer has had a profitable year. In other words, rather than lay off their employees, market-clearing wages are allowed to prevail, and Japanese corporations can reduce salaries up to 35 percent.

If U.S. corporations had this much wage flexibility, they also would be willing to retain their full labor forces, except under the most extreme circumstances. But U.S. labor unions historically have been much more anxious to protect wages than to protect jobs. Only in the last years have American unions shown a willingness to be more flexible in their wage demands. Interestingly, Reich speaks disapprovingly of this wage flexibility.

It should also be remembered that only a minority of Japanese workers in key industries is directly employed by the major corporations. A large percentage of the labor force works indirectly for these corporations, being employed by small firms that operate a contract basis. When demand declines, the major corporations contract out less work, reducing employment in the smaller firms, rather than laying off their own workers.

This is not to deny that Japan maintains a lower unemployment rate than the U.S. Nor should it be overlooked that much of the unemployment currently experienced in the U.S. is explained by the restrictive monetary policy that has significantly reduced the inflation rate. When inflation becomes a persistent feature of the economic landscape, there is no way to bring it under control without precipitating a temporary increase in unemployment. This unfortunate cost has to be paid to correct the inflationary consequences of previously irresponsible monetary policy. In the mid-1970s, Japan suffered higher than normal unemployment when it reduced its inflation rate from over 25 percent to less than 5 percent.

Reich never even mentions the connection between the rate of monetary growth and the inflation rate and the importance of this connection for the unemployment rate. This is hardly a surprising omission; it would be hard indeed for him to reconcile the poor record of government control over the money supply with his view that government can be relied upon to behave in a responsible way.

The industrial success of Japan cannot be credited to government policy to assist private companies with research and development (R&D). The Japanese government has devoted only about 5 percent of its R&D expenditures to private industrial research. In West Germany the figure is nearly 27 percent. In the U.S., by contrast, approximately 50 percent of government expenditures for R&D are directed to private industrial research.[19]

Neither can it be persuasively argued that Japan's success has been the result of government ability to allocate capital to those industries with the greatest promise. Japan's Ministry of International Trade and Industry (MITI) does target particular industries for investment funds from the Japanese Development Bank (JDB). However, these funds are relatively modest--less than 10 billion dollars in a trillion dollar economy. But more important, many of those industries commonly believed to be successful because of government assistance actually have received little help. The iron and steel industry, for example, received less than 1 percent of the loans made with JDB funds from 1951-1972. The hotel industry received about twice as much over the same period.[20] The computer and automobile industries have received surprisingly little special government assistance. Of the total investment made in the machine and information industry (including computers) from 1976 through 1979, only 0.8 percent came from special government loans.[21]

If anything, government may have harmed more than it helped the successful Japanese industries. When the Japanese automobile industry was in its infancy the government attempted to consolidate it by encouraging mergers, the thought being that the number of firms was excessive and fewer firms would be more efficient.[22] When Honda was contemplating its move into automobile production it was discouraged from doing so by MITI.[23] The founder of the Sony corporation, Masaru Ibuka, remembers government policies that would have retarded Japan's electronic industry: "First... tried to stop us from bringing the transistor to Japan, and later they tried to limit the ways we could use it."[24] Fortunately for the Japanese economy, these government efforts to restrict entrepreneurial responses to market opportunities were largely thwarted.

While it cannot be claimed that Japan has an unfettered free market economy, the evidence suggests that Japan's economic success owes more to market incentives and government restraint than it does to political direction of economic decisions. If there is a lesson to be learned from Japan it is clearly a lesson in supply-side economics. Japan imposes a relatively low tax burden on investment income, for example, and personal income is also taxed substantially less than in the U.S.--with perhaps 30

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19 Ibid., p. 4.
20 Ibid, p. 5.
21 Ibid, p. 10.
22 "The Japanese Economic Miracle: An Interview with Hugh Patrick," Manhattan Report on Economic Policy, October 1982, pp. 3-4.
23 George Gilder, "The Entrepreneur," Manhattan Report on Economic Policy, October 1982, pp 12-15.
24 Newsweek, May 30, 1983, p. 28

percent of the population paying no income tax. Japan's 20 percent saving rate is explained in part by the fact that interest income on up to $15,000 in savings is tax-free.

Advocates of a national industrial policy are on weak ground when they point to Japan's experience as evidence that increased reliance on government initiatives is the best way to promote economic progress. The facts indicate the opposite conclusion.

CONCLUSION

The strongest support for a national industrial policy comes from special interests in and out of government, who try to justify government involvement in economic decision making. The actual case for an explicit national industrial policy, both theoretically and empirically, is extremely weak. It is not surprising, therefore, that supporters of such a policy resort to platitudes about productive partnerships between government and business, and cite highly selective and misleading examples of government economic planning in such countries as Japan and West Germany.

For the most part, the arguments favoring a national industrial policy are either vacuous or wrong. And there is no better evidence of the weakness of the arguments for an industrial policy than the enthusiastic reception of <u>The Next American Frontier</u>--a book by Robert Reich that supposedly lays the groundwork for the national strategy. The success of Reich's book is a case of the triumph of rhetoric over substance. Unless they are completely immune to intellectual embarrassment, supporters of a national industrial policy will find Reich's book, and others like it, of little comfort when they are confronted with substantive arguments in favor of reducing, rather than increasing, government's role in the economy.

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