

Industrial Policy Returns from the Grave

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PALO ALTO – One of the worst responses by officials to the financial crisis and deep recession has been to revive “industrial policy.” Once again, governments are using subsidies, mandates, regulation, and capital investment to pick industrial winners and losers, rather than using a broad, even-handed approach.

The new round of industrial policy is occurring in advanced economies such as the United States and the United Kingdom, which long resisted its worst excesses, France, which long promoted national “champions”, and emerging economies such as Brazil and China. For example, French President Nicholas Sarkozy plans to borrow 52 billion euros to promote what his government guesses or hopes will be “growth industries.” Even central banks, especially the US Federal Reserve, have been supporting particular firms and types of assets because of the financial crisis.



Industrial policy is appealing to politicians who can favor key constituencies while claiming to be helping the economy as a whole. But it usually does far more harm than good.

Perhaps the most contentious area of industrial policy is governments’ role in research and development. While governments have an obvious interest in military-related R&D, markets function well when the returns are received and the risks borne by private owners. For basic scientific research, the potential return will be broadly available to any and all, whether or not they paid for it and bore the risk of failure. Because private investors are unable to appropriate the returns, private markets invest too little in basic science.

That is why economists of all political persuasions agree that governments should fund basic science and technology. When I chaired the Council of Economic Advisers for President George H.W. Bush, we doubled the budget of the National Science Foundation. Governments, however, risk crowding out private R&D, the returns from which could be fully appropriated by firms, not only through their own use, but by patenting and licensing the technology to other firms.

The appropriate place to draw the line conceptually is at pre-competitive, generic science and technology. Governments should fund R&D until it reaches the stage where private firms could appropriate (the bulk of) the benefit. It should also remain generic research, thereby maintaining a level playing field for commercial applications.

For example, the computer-linking technology that created the Internet was funded by an agency of the US Defense Department. But it would be foolish for the government to subsidize a particular search engine or social-networking platform.

Governments should not be in the game of using subsidies, taxes, regulation, mandates, loans, and investments to pick particular winners. It simply doesn’t work, and, worse still, it crowds out or stifles potentially valuable competing technologies.

In the 1980’s, advocates of industrial policy praised its extensive use in Japan. But the attempt by Japan’s powerful trade and industry, and finance ministries to micromanage the economy is one reason the Japanese wound up with a burst asset bubble, a lost decade, three recessions, and by far the highest public debt-to-GDP ratio of any advanced economy.

Back then, America’s advocates of industrial policy – often called “Atari Democrats,” after the long since eclipsed maker of early computer games – didn’t even get their facts straight about Japan. While there was a “fifth generation” computer project and one on HDTV, the vast bulk of Japanese subsidies went not to new technologies, but to old-line, high-employment industries like agriculture, mining, and heavy manufacturing.

Similar economic problems permeate the history of the last few decades, from South Korea to Western Europe to the US. In 1980, President Jimmy Carter ran for reelection on a platform of “national reconstruction banks,” industrial policy, and a council headed by labor and business leaders that would decide where to invest tens of billions of dollars. He was trounced by the free-marketeer, Ronald Reagan.

But even in the US, industrial policy is making a comeback. President George W. Bush spent years and billions of dollars pushing a hydrogen car. It got nowhere, and, while hydrogen may eventually become commercially viable for stationery sources, its use for transportation must still overcome some serious obstacles (including flammability and combustibility that is an order of magnitude greater than that of gasoline).

America’s massive \$787 billion fiscal stimulus, ostensibly designed to combat recession and create jobs (but so far ineffective) contained immense sums for subsidies to particular industries and technologies, almost \$40 billion for clean-energy programs alone. While firms and investors take the funds, private financing for commercial alternative-energy projects *is* widely available; an immense number of venture-capital funds worldwide are devoted to alternative and clean energy.

Government should set general goals for energy and the environment and then let entrepreneurs, investors, and consumers decide how best to achieve them. It should fund basic scientific and technological research applicable to these issues. But no policy makes sense if it cannot be sustained without long-term government support.

Whatever the dubious temporary merits of reviving industrial policy in a deep recession, governments need an exit strategy before the programs become permanently entrenched and develop powerful rent-seeking constituencies. Vast amounts of debt-financed spending will require higher future taxes, which will divert capital and labor from higher-value uses than can be sustained without permanent government lifelines.

Industrial policy failed miserably in the 1970’s and 1980’s. Allowing governments to pick industrial winners and losers is just as bad an idea today.

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