Industrial policy

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About the definition

"Any random collection of six economists is sure to produce at least a dozen different opinions on the subject, not least because many economists have trouble in reconciling their gut reaction that industrial policy should not exist with the obvious fact that it does".

(Geroski P.A., 1989, *European Industrial Policy and Industrial Policy in Europe*, in "Oxford Review of Economic Policy, 5(2), pp. 20).

Industrial policy within economic policy

- Economic policy is the set of principles ruling the action or inaction of the government within the economic activity (Robbins, 1935);
- Economic policy: the study of the behaviours aimed at influencing the economic phenomena in order to direct them in a specific direction (F. Caffè, 1978).

Intervention of the State for the **collective interest**.

Our definition of industrial policy

- A set of measures planned, promoted and organised by a **public subject**
  - with a **coercive or orientation** power
    - aimed at influencing the **industrial system** (or part of it) according to directions that **differ** from what would have happened without the measures
      - in order to perceive **aims** that are **relevant** to the public subject.

IP timeline

- Post war period:
  - WEST: the reconstruction, the boom and the “entrepreneurial” state (protectionism, import substitution, export subsidies, self sufficiency, SOEs; national champions,…);
  - EAST: the reconstruction, the planning and the industrialisation
- 1970s: crisis and the “saviour” state: industrial policy allowed and foreseen;
- 1980s-1990s: Reagan and Thatcher era: free market, deregulation, liberalisation, privatisation, government spending cuts, the Washington Consensus
- Industrial policy today: the 2007 crisis and the entrance of emerging countries.

Washington Consensus: A set of economic policies designed by World Bank, IMF (International Monetary Fund) and Treasure Dep. of US Govt. The aim was to reproduce within less industrialised countries favourable conditions in order to obtain in the short run stability and economic growth.

The WC is based on a Western paradigm (model) imposing on debt countries the following reforms: macroeconomic stabilisation, liberalisation (trade, investments and financial), privatisation and deregulation (minimum or null intervention of the government in the economy). Strongly criticized.

Why a need for industrial policy?

APPROACH A – Market failures

- The market is not always able to guarantee **efficiency**: market failures. In these cases – **AND ONLY IN THESE CASES**– the government is asked to intervene in order to correct them.

APPROACH B – Social welfare

- The market is not always able to guarantee optimal and desirable **social conditions**. In these cases the government is asked to intervene **INDEPENDENTLY FROM EFFICIENCY**.

Approach A
Market failures

1) **Externalities.** Positive or negative spill-over effects unintentionally created by the activities carried out by an agent on individuals that are different from those directly involved in the consumption or production of a certain good/services AND these effects are not captured by market price. This situation causes inefficiency because the agent carrying out the activity does not consider in his decision of all of the costs / benefits associated to his choice, especially because such costs/benefits are mainly fall back on external actors (who did not take part in the decision).

   Consequence: there is not a market on which to exchange such goods (**incomplete markets**), and the neoclassical theory does not apply anymore. Tendency to over-produce negative externalities (because the producer does not bear the whole cost) and to under-produce positive externalities (because the producer is not able to force all beneficiaries to pay for the benefits originated from his decision).

Market failures (cont.)

2) **Public goods**, characterised by **non rivalry** (even if used by an actor, it can be used also by the others) and **non excludability** (no one can be a priori excluded from its use).

   In this case the market is not able to guarantee an efficient exchanged quantity because of <u>opportunistic behaviours</u> of individuals: in the case of public goods, once they are produced they are freely available for everybody and no one would be incentivised to pay for buying them (and therefore no one would be available to produce them).

3) **Merit goods.** Socially desirable goods, everybody in the society has the right to access at least to a minimum level of such goods (the “minimum” varies across societies). Usually under-produced because prices have to be kept low to grant access to everybody.

   Demerit goods are goods which are socially undesirable, and which are likely to be over-produced and over-consumed through the market mechanism (usually related to negative external economies). Examples: cigarettes, alcohol, drug.

- Is plastic surgery a merit good?

- Is the concept of merit good homogeneous at world level?

State (or public school)

- Philippines: all levels of education (incl. university)
- Bangladesh: year 1-10
- Denmark: all levels of education (incl. university)
- Italy: income-related state funding

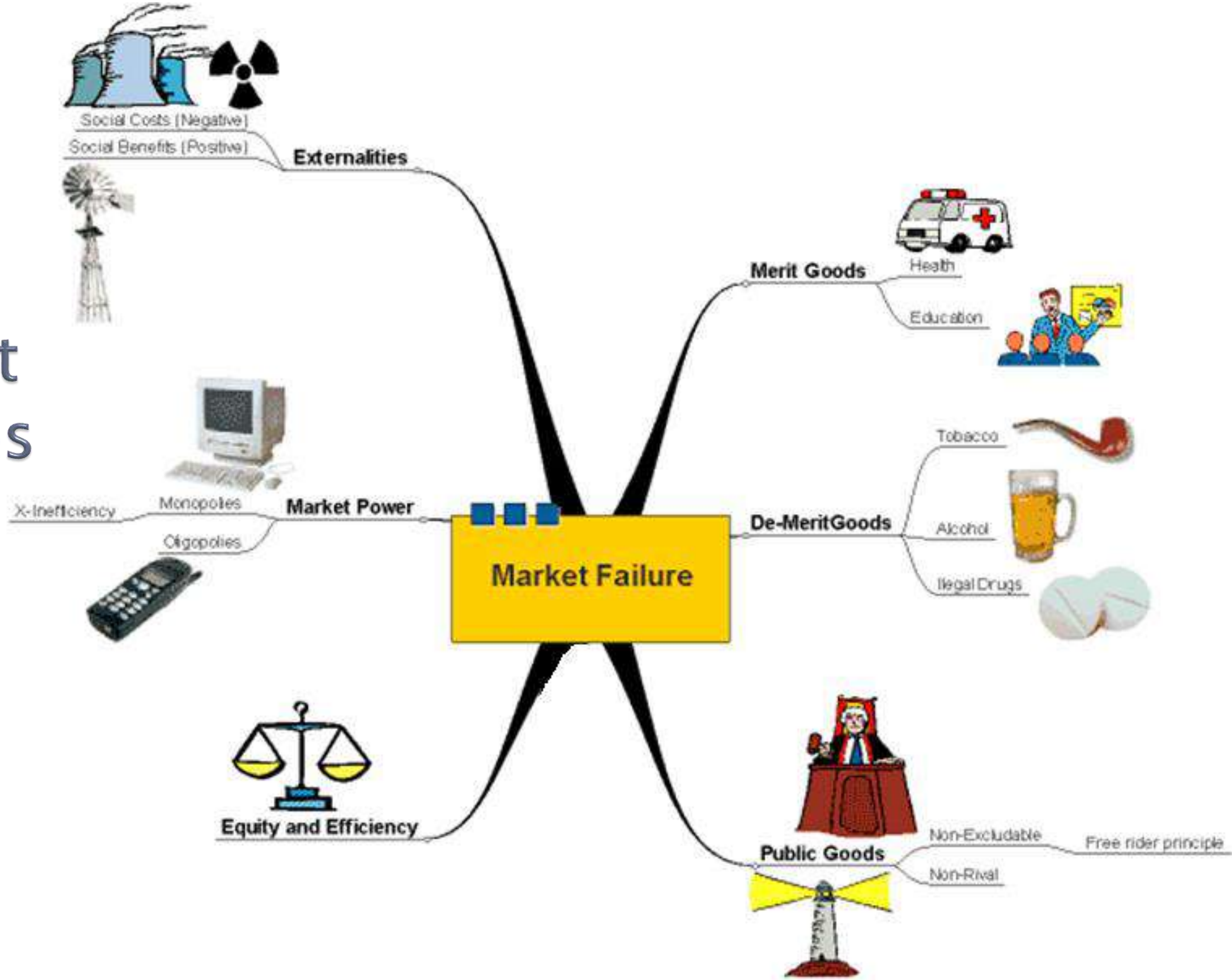
Market failures (cont.)

4) **Coordination problems**. In reality, not always vendors and buyers are able to meet easily, or to know about their reciprocal existence, or to easily gather the information on characteristics of goods or exchange conditions. Since sometimes the search process may be highly expensive, not always individuals will persist in searching the best exchange conditions.

5) **Non competitive markets**. The presence of a non-perfectly competitive market (ex. monopoly or oligopoly) in some cases can give birth to a situation in which there is a limitation in the exchanged quantity and an excessive price. This is due to the incapacity of the market to drive the system towards optimal outcomes.

6) **Goods not suitable for market exchange**, for example for social or ethical reasons (ex. blood or organ donations).

Market failures (recap)



MARKET FAILURES

JUSTIFY →

GOVERNMENT INTERVENTION (INDUSTRIAL POLICY)

Approach B – Beyond market failures

In practice, the government intervenes **not only** in case of market failures, but also in order to reach specific aims:

1) Strategic economic goals: selective industrial policies aimed, for example, at increasing national competitiveness (ex. national champions), favouring development (ex. objective 1 or 2 EC policies) or bailing-out specific companies (ex. GM in the US; Berco).

2) "Meta" economic goals: general aims going beyond the mere economic sphere. This is the case of industrial policies aimed at improving the income distribution, or the environmental and social sustainability of growth. IP becomes a tool through which a nation (region/area) promotes its own model of development and society.

Critics to policy intervention: the government failures

A part from the aims justifying the policy intervention…..

1) … is it correct to assume that the public actor serves the collective interest instead of those of some groups or some individuals? (government benevolence)

2) … has the public actor always the capacity to intervene in an efficient and effective way? (government omniscience and omnipotence)

Critiques to benevolence:
1a) Self-seeking bureaucrats

Government is not a black box (i.e. an automatic device transforming input into output in an automatic way).

On the contrary it is made by a wide variety of actors (ministers, agencies, etc.) each characterised by its own aims (higher income, prestige, personal power, etc.). This can cause a divergence of the public actor from the collective interest (in favour of those employed in the public administration).

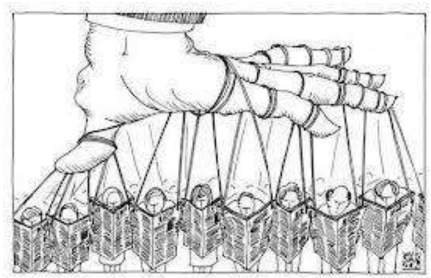
Critiques to benevolence:
1b) External pressures (lobbying)

The State is an arena within which the various interest groups compete, fight or collude in order to define the policy decisions (pretending, for example, ownership rights on assets, funding from the state, etc.).

The different social segments (parties, government, trade unions, business associations, interest coalitions, territories, generations) have a different capacity to self-organise and to affect public decisions => this could lead to the promotion of partial interests and not of the collective interest.

Factors favouring external pressures

- Groups able to offer the majority of votes in exchange for particular privileges.
- Policies based on surveys and interviews (who is the interviewed?) => Short term problem related to the electoral cycle.
- Media manipulation (totalitarian regimes, but not only).
- Difficulties in controlling and evaluating the policy efficacy in the long run.
- Presence of dominant ideologies polarising consensus
- Sovereignty
- Corruption and nepotism


2) Critiques to omniscience and omnipotence

Is it reasonable to consider the public actor promoting the industrial policy (even if benevolent) as really able to reach its own aims?

Two main problems threaten the efficiency and effectiveness of the government action:

A) Information scarcity

B) Rent seeking dynamics

Critiques to omniscience and omnipotence:
2a) Information scarcity

There is the risk that the public actor collects and processes the information needed to promote a policy ONLY with costs higher than the benefits created by the policy itself.

In particular, there could be two types of information asymmetries:

1) Between the state and the policy-targeted entities: to identify the most urgent and real problems, to formulate policy alternatives, to correctly evaluate the impact of such alternatives;
2) Between top decision makers and the different bureaucratic levels: possible discontinuities between the political vision (of policy makers) and practical solutions (of bureaucrats), monitoring of bureaucrats' action (principal-agent theory applied to the public sector).

Critiques to omniscience and omnipotence:
2b) Rent-seeking

1) **Rent-creation**: to spend in order to "create" monopolistic position, rent and profit *through innovation* (possibly destroyed by imitators and competition);

2) **Rent-seeking**: "the fight to gain the queen's favours". To spend in order to "gain" from monopolistic position, rent and privileges made available *by the State* (not destroyed thanks to institutional barriers to entry).

   Every policy introduces the possibility to win a rent (ex. licences, long term tenders, ownership rights, etc.).

   Social resources are spent in order to win the rent (gather information on the tender criteria, lobbies to modify the rules, corruption, etc.) and not to maximise profits. These costs, coupled with the missed productive investments, could destroy the benefits of the public policy.

To summarise

Critiques to government intervention suggest that independently from the aims of the policy (market failure, strategic objectives, etc.), the public actor MAY CHOOSE not to intervene because costs could result being higher than the benefits deriving from the policy

Government failure remedies

1. **Information scarcity**
   - to increase the capacity of the government to collect and process information
   - to reduce information asymmetries
2. **Rent-seeking**
   - to reduce the presence of rent seekers.
   - to use mechanisms to reduce the vulnerability of the public actor (ex. random selection, rotation, queues, etc.)

Government failure remedies: the role of policy evaluation

Policy evaluation becomes a fundamental tool:

- To **increase transparency**, and therefore to limit the emergence of opportunistic behaviours among bureaucrats;
- To facilitate the identification of **malpractices** and the design of solution/punishments;
- To facilitate the identification of **good practices** and to foster their diffusion;
- To increase the **communicability** of policy impacts.

In brief

1. The free functioning of the market should guarantee an efficient and socially desirable outcome

2. Sometimes, however, the market fails, and in these cases the government MAY intervene to correct the failure

3. The government MAY decide to intervene also for other societal reasons, independently from market failure

4. However, apart from the reasons for its intervention, also the government may fail, and such failure might cause non-intervention to be the best choice

5. Also government failures may be corrected

Both market and government intervention have costs.
The key question is NOT what are the costs of the state intervention BUT whether the state intervention can guarantee the same efficient resource allocation **than the market** <u>at a</u> **<u>lower cost</u>**.

Reading list (industrial policy)

Di Tommaso, M.R., Schweitzer, S.O., (2013), “Industrial Policy in America: Breaking the Taboo”, Cheltenham England: Edward Elgar Publishers, (pp. 1-41) (available at photocopy shop).

Chang, H.J. (1994), The Political Economy of Industrial policy, London – New York, Macmillan/St. Martin’s Press (chpt. 1: pp 7-32) (available at photocopy shop).