Commentary

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Theory and evidence

Despite his title, Krugman's paper attempts to debunk industrial policy primarily by extrapolating from assumptions, not by offering persuasive evidence. If we assume, ex hypothesis, that markets are the optimal allocators of capital, that economies are at or near full employment, and that other nations do not rely on mercantilist approaches, then there is no need for industrial policy. For that matter, no need for evidence, since the case for planning is mooted by the assumptions. If the textbook assumptions of neoclassical economics were a fair proxy for reality, politically determined interventions in the allocation of investment, by definition, would have to make things worse.

But in practice, these assumptions are highly misleading. Macroeconomically, the economy is far below full capacity. Microeconomically, we know that investors often strive for short-run profit-maximization that often fails to serve long-run industrial well-being; we know (or we should know) that the sum of individual returns does not always equal the best social return. In international trade, we also have exchange-rate distortions, and politically driven decisions by other nations to give priority to particular sectors where we otherwise might enjoy comparative advantage; the normative ideal of Ricardian trade is not a good description of the way much trade is actually conducted. Thus, the question of whether to plan or not to plan needs to be resolved by careful sifting of evidence, not by tautological manipulation of a priori axioms. In an ideal world of near-perfect competition, Ricardian trade might be the best alternative. But the world in which we live offers hard choices between second bests and third bests. In such a world, an illusory quest for an imaginary first best can be the worst choice of all.

The trade context

Choices about industrial targeting, like it or not, are forced on policymakers by trade-injury questions. The pressures of trade back the United States into de facto industrial policymaking. But because planning is ideologically illegitimate, we typically make industrial policy with inadequate information, poorly defined goals, and something less than a full kit of tools.

Consider the recent Harley-Davidson case, which presents the practical dilemmas in microcosm. In July 1983, the Reagan administration agreed to give Harley-Davidson, America's last remaining motorcycle manufacturer, relief from Japanese competition in the form of sharply higher tariffs (from 4.4 to 49.4 percent). This was the rare case where tariffs were raised, not based on a finding of dumping, but because of a finding of injury to the domestic manufacturer. The tariff surcharge will gradually be reduced over a five-year period, during which time Harley is supposed to restructure and recover.

Why was this remedy chosen? In its complaint to the International Trade Commission, Harley contended that it was well along in the process of developing a new, state-of-the-art engine and redesigning its product line; that its new line could effectively compete with Japanese products; but that it desperately needed to retain market share in order to stay viable and raise adequate capital in the interim. Rightly or wrongly, government officials were ultimately persuaded by Harley. The decision to grant protection was preceded by bitter infighting between the more pragmatic officials of the Commerce Department and the free trade ideologues of the CEA.

Like it or not, even the Reagan administration was committing economic planning. Whether the Japanese had improperly subsidized their motorcycle industry was not at issue. As far as this case was concerned, the Japanese were following the rules of free trade. They were driving the last U.S. motorcycle producer out of business mainly on the basis of a superior product. But, rightly or wrongly, this was not considered an acceptable outcome. So trade officials, forced to adjudicate an injury case, found themselves making seat-of-the-pants industrial policy. Officials, in short, were presuming to outguess the market. The market was telling Harley to scrap its capital and its labor, or to make something else. But Harley executives and government officials concluded that given some restructuring Harley might re-emerge as a viable competitor. The U.S. government was playing MITI — but with one hand tied behind its back.

To a great extent, the tiny motorcycle industry (which could well be expendable) is a metaphor for far more important industries — old-line ones like steel, autos, and chemicals, as well as advanced ones like semiconductors, N.C. machine tools, and fiber optics, all under pressure from competitors who are far less sanguine about Ricardian purity. In such a world of administered trade and neo-merchantilism, it is rather too glib to say, as Krugman does, that when a domestic industry falters it is nothing more than the global free market playing taps. Failing to have a deliberate and affirmative industrial strategy in these key industrial sectors invariably leads us to the worst sort of defensive, ad hoc protectionism.

To pursue the Harley case a moment longer, let us reflect on the difference between our de facto industrial policy and Japan's. The United States cannot admit, ideologically, to having an industrial policy. Therefore, there is no mandate for policymakers to consider whether the country needs a motorcycle industry (or steel, or autos, or chemicals). There is no mandate to look into the value of linkages between, say, motorcycles and metallurgy or machine tools. Nor is there an array of policy tools, save trade restraints and perhaps some tax favoritism. But officials did not have the option of offering Harley subsidized loans, or subsidizing applied research into high-stress metallurgy, or brokering a restructuring agreement with Harley's workforce.

What a self-defeating limbo. The practice of free trade has been abandoned; we protect industry after industry. But the ideology of free trade lives on. As the Harley case illustrates, the force of the ideology is no longer sufficient to keep us fully loyal to the conduct of free trade, but just powerful enough to deny us the tools of competent planning. It is a bit like the teenage girl whose scruples lead her to forego birth control, but not sex.

Krugman laments the absence of scientific criteria for industrial targeting. The image is of policymakers, with their tabula rasa, trying vainly to decide which industry is a possible winner. But that is not how life works. These practical dilemmas do not arise in a vacuum. The task for policymakers is not to dream up some hypothetical high-value-added industry, but to decide when someone else's mercantilist targeting should be allowed to consign a viable American industry to oblivion. Sometimes, it may be appropriate to let a whole industry die. Sometimes, it should be assisted to restructure and develop. The absence of perfect criteria is no reason to deny that these choices will

continue to arise, nor is the fact that policymakers dwell in a world tainted by political influence. "Not to decide is to decide."

Employment and productivity

The argument that high-value-added (high-productivity) fields require fewer workers is always true, whether such fields are identified by markets or by planners. But nonetheless, we all want high-productivity industries. The issue of how to reconcile full employment with rapid productivity gains is conceptually a separate issue from the question of whether planning can work. I happen to believe that a modicum of planning — what the Swedes call "active labor market policies" — can take some of the social pain out of productivity gains without depressing the efficient market allocation of capital. The claim that planning is bad because it accelerates productivity and therefore unemployment is a red herring.

Moreover, the contention that productivity gains therefore would, however paradoxically, produce a lower rate of aggregate growth is surprisingly Luddite. It reflects a static, Newtonian view of how the economy digests productivity gains and re-equilibrates. It ignores the impact of the technological advance associated with high-value-added industries. It ignores real gains in output. By Krugman's standard, productivity gains would have the same paradoxically negative effect on well-being, even when brought about by market-determined patterns of capital investment. The remedy to the productivity1 unemployment problem is Keynesian full-employment policy, not resistance, to productivity gains. Ironically, Krugman's argument against labor-saving productivity gains is precisely the one that primitive protectionists employ against free trade.

Linkage criteria

Krugman's attempt to define away linkage industries sets up a straw man. Issue is not whether steel is re-used. Surely steel has more genuine forward and backward linkage effects than, say, fast food. Of course in theory the market will always produce exactly the right amount of investment in linkage industries, in the absence of other distorting factors (e.g., the tax code, OPEC, labor unions, Japan, inflation, idle capacity). In theory, the market is a marvel — but in theory is not where we live.

Eventual competitiveness

Krugman contends (tautologically) that only if comparative advantage is moving our way anyway does targeting make any sense. This totally rules out the possibility of created comparative advantage, or of technological advances stimulated by targeted investment. Did the U.S. have a "natural" comparative advantage in synthetic rubber or in civilian jetliners or in lunar landers before those technologies were invented? Of course not. They were invented, thanks largely to applications of government capital and government-generated demand. Once that intervention spawned the new technologies, it gave us an effective comparative advantage. Not until the French and German governments subsidized the airbus did they attain an equivalent comparative position in airframes.

Worldwide excess capacity is indeed a problem, but it is a hoary problem of capitalism that was around long before planning reared its ugly head (viz., Marx, Keynes, Schumpeter, et al). Consumer electronics is due for a massive shakeout, not because of targeting, but because of over-investment by the market. Free-market agriculture is the extreme example where stable markets cannot exist without government intervention to prevent overproduction that results when each producer, atomistically, pursues narrow self interest.

Excess capacity problems are probably exacerbated by collision of mercantilist Japan with Ricardian America. In general, overcapacity problems again call for Keynesian and managed-trade and market-sharing remedies, not a disdain of planning.

Response to foreign targeting

The issue is really whether we can be successful Ricardians when others are successful mercantilists. Steel is a very good example. Because of other countries' targeting, returns on steel (by market criteria) are low indeed. But is the market sending the right signals? Can we give up the steel industry entirely? If so, how to explain recent administration policy? What happens when apparent market signals to quit an industry are the result of other countries' subsidies, especially when those other countries happen not to share Krugman's ideological assumptions and they believe that targeting can produce positive-sum gains? Do we mistake those price signals for a free market? Do we try to market our ideological assumptions? Is there an effective demand for our ideology in the global marketplace of ideas?

The real question is whether defensive protectionism is adequate, or whether we'd be better off with protection-cum-restructuring, as per Japanese recession cartels and EC's Davignon plan. Even Secretary Baldridge seems to think so; he's revived the steel tripartite.

More sophisticated professional economists' criteria

Krugman's learning curve hypothetical leaves out the case of subsidized research, or subsidized capital, or market creation (procurement) intended to benefit industry as a whole (e.g., semiconductors, textile industry R&D, aviation technology). Static calculation of optimal return on capital misses the point utterly: Gains are dynamic.

The discussion of external economies confuses over-investment by duplication (market waste again) with aggregate over-investment or under-investment in particular sectors. If the market return on steel is inferior, it's a safe bet that industry is not investing in the state-of-the-art metallurgical research for steel. But that may be just what we need to restore the industry to efficiency.

Conversely, there may be wasteful duplication in pharmaceutical research solely because the returns are exorbitant. There is also the case where industry doesn't spend much on R&D because the market does not yet exist (photovoltaics). Subsidized pre-competitive research may be the best compromise between state and market.

Other government-induceddistortions

Yes, indeed, the tax code is an abomination. But was it government-induced or lobbyist-induced? (Don't blame 10-5-3 and Charls Walker on the industrial policy crowd.)

Japanese targeting

This analysis deserves the Pangloss Award for perfect tautological reasoning. The argument is that Japanese targeting couldn't have made any difference, by definition. Either they didn't really target (The Cline-Saxonhouse hypothesis), or if they did try to target it didn't matter, since only natural comparative advantage can produce real gains (again by definition). Remember Candide: This is the best of all possible worlds, because if it could have been different, it would have; human intervention can't improve on nature. This line of reasoning eliminates the need for evidence. What conceivable evidence would persuade Krugman that Japan successfully targeted? If none, then this is pure tautology.

Is Japan's impressive gain in human capital a tribute to Heckscher-Ohlin comparative advantage, or to targeting? Having advanced industries in which to train and employ advanced workers is one good way to maintain a highly skilled workforce. We trained 300,000 skilled machinists during World War II, mainly because we needed them to build several hundred thousand planes and Liberty ships. Why train American metallurgists if there's no metal industry? Is this perhaps another externality not calculated by market return?

Steel: the refutation that wasn't

Krugman argues that Japan forged ahead in steel because the preconditions were right: cheap labor, cheap capital, transferrable technology, and declining demand. But how does that prove that industrial policy made no difference? These preconditions were arguably necessary, but were they sufficient? The Japanese industrial system is typically financed by relatively cheap, highly leveraged capital. In general, the Japanese banking system (which is the main source of finance) takes a chance only on a big new venture (like steel) when there is government backing for it. Otherwise, the debt-equity ratio would be plainly imprudent. In the case of steel, there was also government subsidy, as well as substantial protection from imports (the usual MITI targeting formula). What evidence does Krugman have for the proposition that development of a Japanese steel industry would have happened anyway (and at the same pace)?

The most obvious benefit of Japanese steel targeting is that it gave Japan relatively cheap inputs for other major exports (cars, ships) and that it provided a winning export product in steel itself. Steel may be just a low-yield product, but the Japanese seem justifiably pleased with it. (As Crandall points out, nowhere does steel earn a market rate of return. So what?)

Implications for the U.S.

Is the villain really high wage costs? Wages are 12 to 15 percent of steel production costs. In fact, a bargain involving wage restraint traded for capital subsidy and job security is very possible, only nobody is proposing it. The absence of any forum in which to broker that bargain is another reason why an industrial policy for steel might produce positive-sum gains.

Semiconductors

In fact, MITI's policy did not include just subsidized cooperative research. It aggressively kept U.S. firms out the Japanese market, except where MITI could coerce technology transfer concessions and joint ventures. MITI also guaranteed markets for semiconductor producers during the trough in the business cycle, while our de facto industrial policymaker for semiconductors — the Pentagon — did not. As Krugman indicates, MITI also links development of Japanese computer industry to Japanese semiconductor production, so that emerging semiconductor capacity has a big, assured domestic market. The conclusion that none of this mattered is a heroic leap; it is deduced from theory, not from any substantial evidence.

My conclusions

Debunkers of industrial policy need to pay more attention to evidence, especially to comparative institutions. There are indeed serious caveats for industrial policymakers in the American context. One is that we are not a corporatist society. Bargaining is much messier and more diffused here than in Japan. Politics do intrude. Politically influential industries will undoubtedly get protection under an industrial policy regime. But they get protection anyway, and under the present regime it is the worst sort of protection. In 1955, this issue would not have arisen. But today, trade forces the issue; we cannot duck it by pledging allegiance to the market.

A second caveat: Industrial targeting is the last 10 percent of sound economic policy. The first 90 percent is good macroeconomic policy, and above all a policy of full employment. Liberals who have latched onto the industrial policy theme as a new agenda, when the old agenda hasn't been completed, make a disasterous error. As Krugman hints, if unemployment is 10 percent and we restructure steel to make it more competitive and productive, unemployment will just rise to 11 percent. For restructuring to work, there have to be jobs to shift the relocated workers to. A measure of targeting is not beyond the competence of government, and it's probably necessary. But it's the frosting, not the cake.

The real world, as opposed to the world of abstract models, is a world in which institutions count, and in which statecraft can sometimes make positive gains. To believe otherwise is not only to hide in the arrogant certitude of dogma, it is to be deeply cynical about democratic institutions.