THE CASE AGAINST "INDUSTRIAL POLICY"

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INTRODUCTION: THE INDUSTRIAL POLICY GAME

In recent years there has been renewed interest in the area of "industrial policy". For many people it is seen as a possible cure for many of the problems associated with low growth, high unemployment and rapid technological change. Demands for industrial policies come from many different quarters, and many benefits have been claimed for them. Nonetheless the economics profession as a whole tends to be unsympathetic, and the consensus among economists appears to be that the conditions required for a welfare-improving industrial policy are unlikely to be satisfied in practice, even though they are theoretically possible. The essence of the argument is that government officials are generally unable to out-guess the market, and though we can visualise market failure situations where intervention might be called for, it is very unlikely that officials could spot them. Even if they could, they would almost certainly lack the information and the incentive to frame the right sort of policy, In the face of difficulties like these economists tend to argue that it is probably better to stay clear of industrial intervention altogether.

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Industrial policy usually begins with some special-interest group which has a lot to gain from intervention and therefore lobbies for it. The government then turns to its economic advisors, who try to assess whether a reasonable economic case can be made for government intervention. In making its decision the government will take this advice into account along with many other factors. The argument of this paper is that the chances of industrial policies arrived at in this way being beneficial are virtually zero.

We are asking the wrong questions if we try to evaluate industrial policies on a case-by-case basis but take as given the broader context within which policy gets made. The appropriate role of the economist is not so much to evaluate the merits of particular interventions, but to assess the framework of *rules* within which the particular decisions are made. Many analyses of industrial policy are inconsistent in that they take into account the incentives these rules provide for private agents, but ignore the incentives facing agents in the public sector, that is, the politicians and the civil servants. A consistent economic analysis of industrial policy must consider *all* the incentives faced by *all* the major players in the industrial policy game. When one carries out such an analysis then one sees that the chances that 'second-best' arguments for intervention will produce a 'first-best' outcome are virtually nil. Indeed, one can go even further and argue that however sound the 'second-best' arguments might be, the actual policy adopted will produce a 'third-best' outcome. In short, the 'second-best' arguments with which economists typically concern themselves are basically irrelevant. It follows that we should be advocating a policy of industrial *laissez-faire.*

THE MAIN PLAYERS IN THE GAME

There are four main players in the industrial policy game as it is currently played. They are the special-interest groups, the policians, the civil servants and the general public. The actual outcome of the game will depend on each of these groups and the various incentives they face.

Consider now the special-interest groups. These tend to be homogenous and small relative to the population, and they have very well-defined interests. They can therefore organise themselves and lobby quite easily. The economic rents these groups can gain from the adoption of particular policies will often be very substantial relative to the size of the groups. They therefore have the incentive as well as the means to lobby for the kinds of policies they want. Lobbying consists essentially of the buying of influence. It usually involves the establishment of a formal organisation to put forward the group's point of view. It can sometimes involve the straight bribery of the politicians or officials who make the key decisions. It can also involve bribery of a more subtle kind, as when a pressure group givees support to those politicians who are sympathetic to its interests. The lobbying process also has a strong propaganda element to it, and the group has an incentive to make its proposals seem as widely acceptable as possible. It will generally try to persuade others that what it wants will also promote the social interest as well as its own, and it may even believe that itself. Such arguments usually take the form of: "Canada would be better off if it had a bigger such-and-such industry." One is meant to conclude from that that supporting the industry in question is in the national interest. Arguments like these are of course intellectually disreputable because they ignore the foregone opportunity. The argument only makes sense if the funds used to support the industry have a zero opportunity cost. But this will not be the case in a world of scarcity and the funds channelled in one direction may well have been better put elsewhere. The fact that we would be better off if a particular industry were bigger rather than smaller with other things being equal is beside the point. Other things are simply not equal.

The second set of players are the politicians. These are the people who, at least in principle, make the key decisions. In doing this they are supposed to be guided by the national interest. In practice the framework within which they operate makes this very difficult for them to do. For one thing, the incentives they face often reward them for acting against the national interest even when they can clearly perceive what it is. For example, if they are to be re-elected they need to respond to voters' wishes, and they need to pay particular attention to voters in marginal ridings. The temptation to 'paper' crucial ridings is often too hard to resist. Similarly, the more vocal and better organised a pressure group is, the harder it is for the politicians to resist and the more likely they are to accede to its demands.

The next set of players are the civil servants. Politicians rely heavily on the civil service for the expert advice they need on which to make their decisions. If the civil service has its own interests and biases then it will be very difficult for the politicians to avoid reflecting these in the policies they eventually adopt. The function of civil servants is to give ministers expert advice and to carry out any monitoring or regulatory duties they are assigned. Though their advice is supposed to be unbiased civil servants in the industry ministries have every incentive to recommend policies of industrial intervention. Indeed, the very existence of the ministries is predicated on the assumption that the government is to have an ongoing industrial policy. If the civil servants were seriously to recommend industrial *laissez-faire* then the government's logical response would be to turn around and abolish them. In these circumstances the civil servants can only be expected to give advice on what form the industrial policy should take; they cannot be expected to give advice on the deeper question of whether there should be industrial intervention in the first place. Another important factor is that this kind of work environment is likely to be very uncomfortable for economists of a *laissez-faire* disposition, so the people who get ahead in these ministries would be temperamentally sympathetic to industrial intervention anyway. Add to this the tendency of bureaucracies to create extra work for themselves and one realises that these ministries have at least as much at stake in industrial policy as any of the outside pressure groups.

The last major player is the general public. This is the group whose interest the government is supposed to look after, and to whom as electors the government is theoretically accountable. The general public tends to be a heterogeneous and dispersed group with few common interests. It is therefore hard to mobilise when its interests are threatened. It is also the group which has to foot the fill for the government's industrial policy. It does this not only through the higher taxes it has to pay for industrial subsidies but also through the higher consumer prices that industrial policy often brings in its wake. While the benefits of industrial policy are usually quite clear-cut and are large relative to the number of beneficiaries, the costs it imposes are much more difficult to pinpoint and are widely dispersed among a large number of people. These costs would nonetheless be quite substantial when added up, and that is the reason why the interest of this group is usually synonymous with the national interest. But because the general public is hard to organise, and because the costs it incurs are widely dispersed and hard to assess, it suffers from a serious disadvantage in the lobbying game. To the extent that politicians respond to lobbying, therefore, they will tend to sacrifice the general interest in favour of special- interest groups who are better able to present their case.

THE OUTCOME OF THE GAME

The ideal outcome of the industrial policy game would be one where the government generally abstained from intervention but intervened in the rare cases where it was in the general interest. This can only happen if the government resists both the outside lobbyists and the inside ones within the civil service. This is virtually imposs-ible under the present rules of the game. After all, the whole point of lobbying is to make it as difficult as possible for the government to refuse what is wanted. Any government that does refuse pays a price in terms of offended powerful interest groups, jeopardised seats, and so on. There is therefore very often a conflict between the government's duty to serve the general interest and its instinct to remain in power. In addition, we have seen that the very existence of industry ministries presupposes a policy of ongoing intervention. This means that intervention is the rule rather than the exception, and it is correspondingly more difficult to refuse any particular request for assistance. And even if the government was prepared to risk the displeasure of powerful interest groups, it would still have to distinguish between the many cases where intervention was not justified and the few where it was. Each lobbyist will try to argue that the intervention he wants is in the general interest, and even in the best of circumstances distinguishing between the two is very difficult. It is even harder when the civil servants on whom the government relies will generally argue in favour of intervention regardless.

The outcome of the game will tend to reflect all these incentives, and one can virtually guarantee that it will not be a socially optimal one. The rules of the game are all biased towards intervention. The spoils of that intervention will go to the influential and powerful to the detriment of every-one else. This is a classic example of the old proverb "Every man for himself, God for us all, and devil take the hindmost." The costs of the game will be many and varied. They will include a great deal of misallocated resources. They will also include a considerable deadweight loss consisting of the resources used up in lobbying for economic rents. These resources are lost because they are use up in an activity which contributes nothing to the welfare of society overall. The scale of this loss is hard to assess, but one can get some idea of it from the size of the lobbying industries which have grown up in Ottawa and to some extent in the provincial capitals. To these one should also add many of the resources used up in the federal and provincial industry ministries.

Another cost is much less tangible but possibly much more sinister. This consists of the tendency of the current system of rules to undermine the integrity of public life. With so many resources up for grabs politicians and civil servants inevitably come under a great deal of pressure to compromise themselves. The scope for bribery of one sort or another is enormous. This is not restricted to straight monetary bribes which are in any case prohibited by law. Much more widespread and difficult to monitor are practices like offering politicians company directorships and offering civil servants lucrative jobs after they leave the service. Another aspect of it is the pressure that politicians com eunder to use their discretionary powers to further their own political interests. One of the most flagrant examples of this is the practice of chanelling public funds into marginal ridings so as to stay in office. The funds that have been abused in this way run into billions of dollars. These funds represent not only a massive misallocation of resources but a serious undermining of the fairness and integrity of our political system.

THE NEED TO CHANGE THE RULES OF THE GAME

The problem is not so much that intervention in this or that industry is good or bad. Specific interventions may be very harmful, and criticising them may alleviate some of the worst excesses, but to criticise particular instances while accepting the underlying rules of the game is to attack the symptoms rather than the cause of the problem. The essence of the problem is that the rules under which the game is currently played encourage an outcome which we know is positively harmful. The only way we can alter the outcome is by changing the rules themselves. There are three particular features of the current set of rules which we would want to alter to rectify the situation: first, special-interest groups have a major advantage over the general public in organising themselves and presenting their case. This will tend to produce a bias towards specific interventions; second, under current arrangements the government is held directly accountable for far too many aspects of economic life. When an industry closes down, for example, the first question many people ask is what the government is going to do about it. So long as issues like this are considered to be the government's responsibility then it can hardly refuse to intervene; third, when it assesses industrial policy the government relies for advice on its own civil service which has perhaps the biggest stake of all in the industrial policy game. This will also produce a bias towards intervention.

I would suggest that the answer to these problems is a policy of industrial *laissez-faire.* Of course one can object to this that once in a while we might miss a worthwhile opportunity to intervene, but against this we must remember that the current framework gives rise to far too much intervention. It is better not to intervene at all and be wrong one time in a hundred than maintain our current interventionist set-up and be wrong ninety-nine times out of a hundred. But even with the best advice those rare opportunities to intervene are extremely hard to spot, and the issue is not whether we should intervene in those instances, and not in others, but whether we should have an interventionist framework which leads us to intervene most of the time where it is not warranted, or whether we should adopt a *laissez-faire* stance which will give us the right policy most of the time but might occasionally be wrong. In any case we must also bear in mind that special-interest groups will always have an advantage in presenting their case, and if we are not careful this will always bias us towards intervention. To counteract this tendency we ought to adopt rules which will bias us *against* intervention. *Laissez-faire* thus has the advantage that it neutralises the bargaining advantage of special-interest groups. It also has the advantage that once those groups realise that lobbying is getting them nowhere they will eventually give it up. This will remove the deadweight loss we incur at the moment.

It would be naive to assume that abandoning intervention and adopting *laissez-faire* would be easy. In the first place it would require a clear government commitment, and that would be difficult to maintain since *laissez-faire* would deprive many powerful groups of what they regard as legitimately theirs. The political fall-out from a move to *laissez-faire* could therefore be very uncomfortable.

If the government is to maintain such a policy, however, it is critical that it do something about its own in-house pressure group. One possibility would be to clip their wings and downgrade the industry ministries to the status of monitoring and statistics-collection agencies. The danger with this is that it leaves the basic ministry intact, if only on a reduced scale, and it is always possible that it will re-emerge someday to advocate industrial policy again. To avoid this I would recommend that the statistics-collection, worker-safety and whatever other useful functions these ministries perform be hived off to other ministries, and that the industry ministries themselves be simply abolished. Such a move would also have the advantage of making quite clear to everyone that the government was committed to its policy of *laissez-faire.* The stronger that commitment is seen to be, the less it will be challenged and the easier it will be to maintain.

To keep to such a policy in the long run requires much more than acceptance on the government's part. It must also gain acceptance in the community at large. No policy of *laissez-faire* can be sustained if the public continue to demand widespread intervention. It is essential that the terms on which public policy is currently debated shift: the presumption that intervention is justified unles one can prove the contrary must at the very least be reversed. But since there does not exist a rule which would tell us when an intervention is beneficial, I would suggest that we go further and presume that *no* intervention is justified.

It is common to object to *laissez-faire* that it is somehow 'impractical' and of little use to policy-makers who have to operate in an imperfect world of continuous government intervention. Against this one can argue that there is nothing inevitable about intervention and we do face a genuine choice as to whether we want to continue it or not. That *is* of little use to policy-makers trying to run today's industrial policies, but in the longer run it is much the more important issue and we must be absolutely clear about it. To accept the current set of rules and criticise particular instances of industrial policy is to miss the whole point; the essence of the problem is that it is the rules themselves which give rise to such an undesirable outcome. If we are ever to tackle the problem we must revise those rules; the particular instances will then take care of themselves.