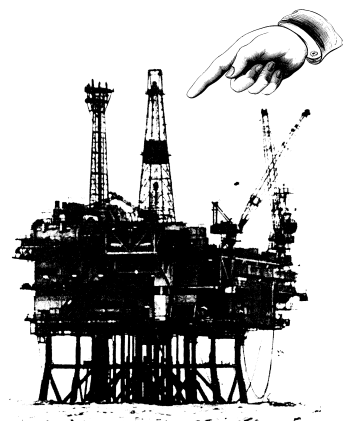


THE FOLLY OF INDUSTRIAL POLICY

MATTHEW O'KEEFFE



Every individual necessarily labours to render the annual revenue of society as great as he can. He generally neither intends to promote the public interest, nor knows how much he is promoting it.

He intends only his own gain, and he is, in this, as in many other cases, led by an invisible hand to promote an end which was not part of his intention.

Adam Smith (1723-1790), *The Wealth of Nations*

Smith observed, in *An Inquiry Into the Nature and Causes of the Wealth of Nations*,¹ that the market process is moved as if by an invisible hand. What is interesting is that Smith's observation also applies, in a modified way, to politics. The politician, too, intends his own gain, but under very different constraints; for the political process is moved by an all too *visible* hand. While it is the profit motive which makes the entrepreneur tick, it is the vote motive which drives the politician. Politicians want to be seen to be doing something: providing the goodies for some worthy cause, clamping down on some unpopular form of behaviour, putting the world to rights, "planning" our future in one way or another.

Calls for the government to do something are particularly strong in economically uncertain times. We in the United Kingdom are told, by interventionists as different as Gordon Brown and Michael Heseltine, that British industry badly needs an industrial policy — specifically, a policy for picking and backing "winners". But is this what British industry really needs?

One cannot object to those who make the criticism that real markets are less than perfect. What should be objected to is the reluctance of these same critics to extend their realism to the workings of the political process, in its own way far more imperfect. In fact, unless we treat the state as some sort of *deus ex machina* — omniscient, omnipotent, benevolent and trustworthy — we must conclude that the future winners in industry are more likely to be identified and supported by the private sector than by government.

THE RETREAT FROM TOTAL STATE CONTROL

Most interventionists now acknowledge the utter failure of the control economy, and the corresponding vindication (if only by de-

fault) of a market economy of one sort or another. It must be hard indeed to remain a socialist, after the devastating theoretical critiques of Friedrich Hayek, Milton Friedman, Robert Nozick and Ludwig von Mises, and after the practical breakdowns of socialistic economies. It must also be hard for those who have spent their intellectual lives singing the praises of socialism suddenly to abandon it. But honest interventionists no longer call themselves socialists; they realise that socialism — state ownership of the means of production, distribution, and exchange — is not a realistic solution to the world's economic problems. Entrusting economic life in its entirety to state control actually makes matters incomparably more problematic. The men at the political controls simply lack the information they need. As Hayek points out, the relevant knowledge is never given to any one mind, but remains fragmented and localised among individuals and groups.

It is for this reason, upheld by vast experience, that full-blown interventionism has been abandoned. Unfortunately, the conversion has been less than total; interventionism of a more limited kind remains a comforting thought. Some like to imagine that the state can watch over the chaos of the marketplace. The state is still seen as a sort of guardian angel, making its guiding hand felt now and then; this is the appeal of industrial policy. What is not appreciated is that precisely the same reasons which tell against wholesale planning also tell against industrial policy-making.² The would-be industrial policy-maker faces a problem of knowledge very similar to that of the central planner. He cannot possibly know which enterprises and technologies will prove to be winners and which will turn out to be outright losers.

THE CAPITALIST HAS A STRONG INCENTIVE NOT TO FAIL

Obviously private organisations face this problem of uncertainty just as much as policy-makers do. But there is every reason to suspect that entrepreneurs, investment banks, venture capitalists and so on, are better at choosing winners than governments are. In the first place, there is the matter of motivation. The venture capitalist is risking his *own* money. A case in point: the British venture capitalists of 3i (Investors In Industry) support many new enterprises every year, but less than 10% of these enterprises fail.³ No government could claim such a success rate. Particular employees of 3i do their homework extremely well, for they know that their jobs depend on picking winners. 3i as a whole struggles to keep its business failure rate low, since it is this low rate which gives other institutions the confidence to place their funds with 3i; they are confident that their funds will not be wasted on losing ventures. The lesson throughout is a simple one; if the venture capitalist (or entrepreneur, or investment banker) makes too many mistakes, he will simply be driven out of business. He has a very strong incentive not to fail.

Governments, by contrast, risk only public money (i.e. money extracted coercively from the tax-payer). They care less about their mistakes, one suspects, since it is not their own money which is at stake. And we may ask, what would happen if the future makers of industrial policy at the Department of Trade and Industry were to make mistakes continually? The answer is that Gordon Brown,

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FOR LIFE, LIBERTY AND PROPERTY



Michael Heseltine, and other supporters of an activist DTI, would argue that the department had been given “insufficient resources”. While a record of failure will put a capitalist out of business, the same record may be used by a policy-maker to justify a hugely increased budget. A curious reversal of economic logic lies at the heart of interventionism. The result is that the costs of failure are far less for those in the policy process than for those in private enterprise.

THE MITI MYTH

We have seen that the problem of guessing which industries will wax and which will wane in the years to come is a formidable one. We have also seen that the incentive to solve this problem is likely to be more forthcoming from private enterprise than from the governmental process. But let us suppose, for the sake of argument, that the policy-maker could be just as motivated as his counterpart in the private sector; that he could care as intensely about the public interest as the businessman cares about his profits. We will suppose in other words that the policy-maker is a selfless, benevolent individual. Could we then expect the policy-maker to be as successful as his private counterpart in picking winners?

In fact the policy-maker faces a particular difficulty which his private counterpart avoids. The problem is that people do not believe that governments are entirely trustworthy. A good example is provided by the Japanese experience of its Ministry for International Trade and Industry. Supporters of an industrial policy nearly always point to MITI — indeed it is probable that MITI is mentioned more often in Western intellectual circles than in Japanese business circles. What is not mentioned is the huge difficulty which MITI has in eliciting the information it needs from industry. Akio Morita, joint founder of Sony, puts the problem very well.⁴ Sony refuses to discuss any of its plans with MITI, according to Morita, quite simply because the ministry might tell Sony’s competitors. An investment bank, by contrast, will typically work with only one client within each industry, so as to avoid potential conflicts of interest. And a huge amount of future business will always rest on the bank’s reputation for confidentiality. Sony will eagerly supply an investment bank with all the information it needs, if this will elicit the financing for some new project. A private backer will typically try to help a business *compete* with its rivals; a public backer, like MITI, will try to *co-ordinate* a business with its rivals. Little wonder that Japanese industry is so suspicious of MITI.

Morita’s comments on MITI are worth a separate article. The ministry has no involvement with Sony’s present planning. During 1953 and 1954, Sony actually fought with MITI to get permission to import the fledgling transistor from America. MITI was reluctant to give the licence to a young company, preferring, as civil servants do, to pass it on to a big trading company like Matsushita. They could see no use for this new technology! (Sony eventually won permission, and went on to make one of the world’s most popular portable radios.)

SUNRISE AND SUNSET INDUSTRIES

We will suppose, for the sake of argument, that the businessman has greater faith in government. Even if the policy-makers really did seek and find winners, would they back them? A criticism often made of private backers is that they are over-cautious; they are very careful about whom they lend money to, since they want to get their money back. Many entrepreneurs never get a chance, or so the critics hold. There is some truth in this criticism. This caution of businessmen, however, is also one of their strengths — they make fewer mistakes. More importantly, while it is appreciated that financiers work within financial constraints, the fact that policy-makers also work within political constraints has often been overlooked.

Consider the case of sunrise and sunset industries. The industrial policy-makers would presumably operate with a limited budget. (We will not presume that the policy-makers have unlimited funds at their disposal, though this would be in the spirit of the other assumptions we have made for the sake of argument.) Given that

the policy-makers would not be omnipotent with respect to funding, whom would they throw their weight behind?

For the sake of clarity, let us imagine a town with two employers only. One is a bright new manufacturer of computer chips, employing ten people — a sunrise industry. The other is a dying shipyard, employing ten thousand people — a classic sunset industry. Whom would our industrial policy-makers support? It would take an act of spectacular naivety to suppose that policy-makers would support the computer firm *rather* than the shipyard — *even if they wanted to*. The unions, with the sheer weight of numbers behind them, would lobby for funds to be directed in the opposite direction, as would the management, with existing wealth behind them. Most importantly, the politicians concerned would want to be re-elected — they would sooner hear ten thousand voices than a mere ten. Policy-makers are constrained by the vote motive. (Private backers, we should note, are constrained mainly by the profit motive; their concern is with which industry has the stronger future, rather than with which is currently stronger at the ballot-box.) Policy-makers would in all likelihood find it politically impossible to back hopeful newcomers; the vote motive would tend to work in favour of sunset industries, and at the expense of sunrise industries.

The problem with the proponents of industrial policy, then, is that they assume that the state can succeed where the market fails; they assume that the state can be summoned to correct the imperfections of the market. They ignore those imperfections which the state itself engenders. The state is thus treated, quite unrealistically, as a *deus ex machina*. Unless, however, we do indeed regard the state as omniscient, omnipotent, wholly benevolent and wholly trustworthy, we must conclude that industrial policy is a very unpromising option.

“COMMANDING HEIGHTS”

Our discussion has largely dwelt at the theoretical level. But it is also worth pointing to our practical experience of industrial policy-making. The post-war planners of the 1940’s believed that they had formulated a coherent vision for the future of British industry: specifically, they believed that they had identified steel, coal, and shipping as the “commanding heights” of the economy. The subsequent decline of these sectors, for which Thatcherism is often blamed, is more properly attributed to the policy-makers who expanded these sectors out of all proportion. The post-war “planners” did not foresee the development of new alloys, fibres or plastics; they did not foresee the growth in nuclear power, nor the rise of environmental movements, with their hostility to the use of fossil fuels; they did not foresee the growth of the Pacific Rim dockyards, nor the huge growth in air freight. They did not foresee any of these things. But then, how could they have?

It is probably a mistake to search for commanding heights, as if the economic world had a firmly marked out landscape, with the ascendancy of certain sectors set in stone. The economic world is far more like a stormy ocean. It changes constantly, and it is far more difficult to navigate than our aspiring policy-makers would have us believe. Support for industrial policy comes of a mild hostility towards businessmen, combined with a vicarious bossiness and a desire to find easy solutions to the problems of a complex economy. We have paid dearly for the folly of the policy-makers of the 1940’s, and we would be wise to avoid repeating their mistakes in the future.

NOTES

1. Adam Smith, *The Wealth of Nations*, Penguin Books, Harmondsworth, Middlesex, 1970, Book IV, chapter 2.
2. Nicola Tynan, ‘Hayek on Knowledge’, *LSE Review*, Issue 2, Summer 1992, p. 5.
3. Based on a personal interview with 3i, January 31 1992.
4. David Graham and Peter Clarke, *The New Enlightenment: The Rebirth of Liberalism*, Macmillan, London, 1986, p. 93. Chapter 4, ‘Making It’, provides very useful insights into the workings of MITI.