TABLE 13. FIVE-YEAR ECONOMIC ASSUMPTIONS

	Actual	Estimate	Projections		
	1982	1983	1984	1985	1986
Real GNP (percent change, year over year)	-1.9	3.1	5.0	4.0	3.5
GNP Deflator (percent change, year over year)	6.0	4.5	4.8	4.8	4.8
Civilian Unemployment Rate (percent, annual average)	9.7	9.7	8.4	7.9	7.5
Three-Month Treasury Bill Rate (percent, annual average)	10.6	8.8	8.6	7.7	7.4

SOURCE: Congressional Budget Office, The Economic and Budget Outlook: An Update (August 1983), Table 3.

would allow some of the most severely affected industries, such as automobile and machine tool production, to recover from their very low 1982 output levels.

Relying on current policy would be consistent with a growing body of thought that holds that one of the major causes of recent industrial decline was a lack of competitiveness on the part of industrial managers, and that this may now have improved. 1/ The recent recession has forced many managers to become more competitive by cutting costs, reducing inventories, and in general managing their firms with an eye toward productivity improvement (the so-called "fundamentals"). 2/ The new climate should help spur economic performance.

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1. Robert H. Hayes and William J. Abernathy, "Managing Our Way to Economic Decline," Harvard Business Review (July - August, 1980).

2. See, for example, Sheila Cunningham, "How the Recession Is Giving Business a Better Chance for Profits," Business Week (December 27, 1982), p. 26.

One advantage of this policy option is its unobtrusiveness. It avoids the dangers inherent in increasing the level of politicization of economic decision making and it achieves reasonable results without enlarging the deficit, raising taxes, or creating new bureaucracies. This option reinforces the market economy's self-correcting features, particularly the ability to innovate and adapt to change without centralized direction.

Potential Disadvantages

The principal disadvantage of relying solely on current policy is that many long-term structural difficulties are not likely to disappear with the recession. Some forecasters expect economic growth to be slower in coming decades than in the recent past. 3/ Productivity growth rates are not expected to return to historical levels, and unemployment is expected to remain very high by postwar standards. This would leave scope for an industrial policy to address structural problems and aid businesses, workers, and communities in adjusting to long-term trends.

To the extent that current policy does not address structural factors, new jobs will tend to be in the low-wage, low-productivity service sectors, and blue-collar workers will continue to suffer high unemployment. Competitive difficulties in foreign trade are likely to persist at some level, and with them political pressure for tariffs, quotas, and other protectionist measures.

REFORMING CURRENT POLICY

This option includes a set of measures intended, singly or together, to improve the functioning of the economy and the performance of industry. They would modify antitrust policy, reduce regulatory burdens on industry, promote exports, and help workers adjust to changes in the labor market.

Potential Advantages

Proponents of these reforms cite a number of benefits that would be gained from them. First, some current policies are out of date and interfere with the long-term competitiveness of industry. For example, reform of the

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3. See Data Resources, Inc., U.S. Long-Term Review (Spring 1983). It projects real GNP growth as averaging 2.7 percent annually between 1983 and 2008, compared with 3.3 percent in the 25 years to 1981.

antitrust laws, particularly to allow for joint research and development, is advocated on the grounds that foreign competitors can undertake such joint research and that this may give them an advantage over U.S. firms, particularly in high-technology research. Similarly, those who would reform the banking laws argue that the separation of commercial from investment banking limits the funds available for investment and leads firms to take a short-term outlook. They also argue that the legal separation of commercial and investment banking is rapidly being overtaken by market changes in response to previous deregulation, and that these changes should be recognized in law. Such reforms would cost very little; in fact, the deregulation proposals would reduce the government's administrative costs.

Second, even if reforms of current policies did little to improve industrial performance, they would improve the administration of the policies themselves. Industry would be better regulated, and labor programs would be more efficient and effective.

Third, policy reform in the areas of trade promotion and banking reform would put U.S. firms on a better footing with foreign competitors. Export promotion would have obvious benefits for industries in direct competition with foreign producers, even if it did not translate into a net benefit for the whole economy. Banking reform would enhance the power of financial institutions and help their clients to compete better in international markets.

Finally, these options offer a way to address industrial problems without establishing new federal bureaucracies. Some (such as deregulation) would even take the government out of private economic decisions and increase the reliance on market forces.

Potential Disadvantages

The major disadvantage with a reform strategy is that it may be inadequate in its approach to industrial policy concerns. In some cases, such as banking deregulation and antitrust reform, any effect on industrial problems would likely be more a secondary than a primary result of the reform. Other reforms, as in labor policy, would address the symptoms of industrial problems more than the causes of them.

The reform options, as a group, suffer from not being comprehensive in their approach to industrial ills. They are not linked by any overarching view of the economy and its problems. Rather, they are only a cluster of measures that work at the margins of current policy.

Comments on Specific Reforms

Antitrust. In reforming antitrust policy, one must believe that some non-competitive activities are preferable to open competition, and that pooling industrial resources would offer net benefits from economies of scale greater than the gains from diversity and competition. This is credible, albeit open to dispute. Certainly in some countries, notably France, Germany, and Japan, this point of view prevails. If the sources and types of competition in the United States have changed substantially over the years, then it may be reasonable to allow antitrust exceptions based on those changes. Many, however, believe that efforts to foster vigorous competition have served the country well.

Banking. The option of reform in the area of financial markets, in particular, revocation of the Glass-Steagall Act, is based on the belief that such reform would ultimately increase the pool of savings available for investment and/or lengthen the time horizon of investors, leading to greater employment and economic growth. But it is not at all obvious that repeal of the Glass-Steagall Act would increase the pool of savings available for investment. The existing separation of commercial from investment banking may not in itself reduce the pool of financial resources, but merely divide the control over that pool. Neither is it obvious that the creation of universal banks on the order of the European model would lengthen the time horizon of bankers, investors, or business firms, which is probably more sensitive to interest rates and other market signals.

Social Regulation. While reform of regulatory practices in areas such as environmental protection or occupational health and safety may be desirable, the burden of such regulation does not appear to have been a major factor in U.S. manufacturing competitiveness. This country does not regulate businesses to a greater degree, or force them to spend more on health and safety, than do other industrialized nations. In fact, many foreign regulatory practices were borrowed from the United States.

Trade. Export promotion programs are predicated on the notion that creating greater sales in some product markets will add to employment and income. However, such programs are unlikely to have net positive benefits to the economy as a whole. 4/ This is particularly true of concessionary export financing. By shifting resources from one segment of the economy to another, and subsidizing foreign consumption, the government creates new burdens as it creates new benefits. New jobs may be created in promoted or

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4. David P. Baron, The Export-Import Bank: An Economic Analysis (Academic Press, 1983).

protected industries, but these may be offset by job losses in other sectors that are not likewise promoted. Under floating exchange rates, increases in exports in one sector result in currency appreciation that acts to decrease exports in other sectors and to increase imports. Export promotion programs also tend to be costly from the standpoint of the federal budget. In many cases, they only subsidize exports that would have occurred without the program.

Labor. Finally, labor adjustment programs can help the economy achieve higher levels of output and employment by speeding workers' adjustment to economic change. They can do this only to a limited extent, however, because the number of dislocated workers is relatively small and the number who are assisted in finding jobs is even smaller. Programs such as job search assistance and retraining are more likely to speed adjustment than simple income support programs, which may even retard adjustment.

NEW INSTITUTIONS

This section examines proposals for new programs and institutions. Since none of these institutions now exists, the discussion must be based on assumptions about the way they would work and the effect they would have on the economy. That is, what conditions must hold true for these institutions to be effective?

An Information/Consensus Agency

Proposals to establish an information/consensus agency are based on the idea that information itself helps to diminish risk and uncertainty in business. To the extent that agreed-upon "facts" about the future can be developed and that individuals, firms, and government policymakers believe and act on those facts, then the future will be less uncertain and action less risky. If such an agency could achieve consensus on a course of action it would establish a basis for investment and growth in output. In its consensus-building capacity it would follow the example of blue-ribbon national commissions such as the President's Social Security Commission and the President's Commission on Strategic Forces.

Potential Advantages. Compared to the other types of proposed new institutions, the information agency would entail the least risk of damage if it should fail. Since it would have no overt power to compel action, it would not interfere with the prerogatives of private decision making in the economic system. Its effectiveness would depend strongly on the public's willingness to follow the agency's lead. If it failed to build consensus and develop a following, it could be ignored without much danger.

Potential Disadvantages. The agency might not achieve anything, particularly if it had no financial resources to back up its decisions. Many national commissions have attempted to establish consensus and leadership through the strength of analysis alone, only to fail. The British National Economic Development Councils (NEDCs or Neddies), upon which this model is based, have been almost totally ineffective because they lacked power to compel compliance. The Neddies were themselves based on the French indicative planning system, but unlike the French model they had no resources to back up their decisions.

The viability of a purely information-oriented agency would depend on its ability to bring together a variety of groups, including labor, business, and consumers. Achieving responsible and fair representation would be difficult; achieving consensus and positive action would be even harder.

Finally, there is some possibility that a consensus agency, to the extent that it influenced investors and managers, would encourage conformity to a single view and inhibit independent action. It might even make adjustment to changing conditions slower and more difficult. Some analysts believe that consensus-building in Japan has been partly responsible for a slowness in technological innovation and new-product development. Japan's comparative advantage, thus far, has lain in copying and improving on the production of products developed elsewhere.

A Coordinating Agency

An effort to coordinate federal policies toward industry would probably require changes in some of the policies cited in Chapter III. It might also lead to greater expenditures if the agency used subsidies to achieve policy goals. More important for this discussion, however, are the general outlines of such an agency.

Potential Advantages. The advantages of an executive-branch coordinating agency would lie in its being a new voice in policy discussions, concerned with the impact of decisions on industry and with the establishment of greater consistency in policies toward industry. It would help to avoid policy conflicts, such as reducing trade adjustment assistance funding on the one hand while pursuing free trade on the other, which creates more demand for such assistance. If it served to reduce the number of policymakers responsible for industrial concerns, that alone might increase government efficiency and reduce administrative costs.

One further advantage of a coordinating agency is that it would help to focus attention and define industrial policy issues both inside and outside of government. The establishment of a government agency lends legitimacy to the issues it deals with; by giving definition to a problem and focusing public and private resources on it, it creates the means for finding solutions.

Potential Disadvantages. Consistency in policy may be politically and administratively expensive to achieve. Some measure of competition among specialized agencies may be more helpful than designating a single responsible agency, which may be captured by special interest groups. A centralized agency might also become too bureaucratic and too interventionist in its support of specific industries, to the detriment of other sectors of the economy. Finally, if it led to the establishment of additional layers of coordinators, as some proposals suggest, it would raise administrative costs and might result in greater administrative confusion.

Examples of failures of such agencies abound. In Japan, MITI actually tried to reduce the number of automakers and inhibit their development. That the industry was able to circumvent MITI's position is a testimony to the strength of Japan's private economy rather than to MITI's foresight. MITI has also made more disastrous blunders, such as promoting a national petrochemical industry based on expensive naphtha, and overexpanding Japan's shipbuilding industry. French planners, too, have had more than their share of major errors, such as Plan Calcul's failure to create a competitive data processing industry. Even France's much-heralded Airbus is heavily subsidized and may never return an economic profit.

No U.S. government agency now has the authority or resources to reorganize the steel industry or provide financial support for the adjustment programs that may be a necessary part of such a reorganization. An industrial-policy coordinating agency might need such powers to be effective. Merely reorganizing existing agencies would not create such powers. Indeed, the main point may be that the President and the Congress are ultimately responsible for policy decisions. No reorganization can change or create policies not agreed to by the President and the Congress.

A Financial Institution

Proposals for a financial institution find their rationale in the limitations of the existing capital market and in the desire for political solutions to problems that cannot be solved by the market alone.

Potential Advantages. Such an institution would offer advantages if certain conditions were met. First, one must believe that recurring economic problems--specifically, those related to slowing industrial productivity and slower growth--have to do with structural difficulties in the economy that lie outside the bounds of conventional fiscal or monetary policy, or cannot be corrected by the reforms of current policy discussed above. If so, there is a case for pursuing policies targeted at these structural difficulties, and for setting up an agency to handle them rather than tying up the Congress with such matters.

This solution presumes that the private economy cannot correct these difficulties on its own. For example, individual firms may not be able to perceive (or capture) the profits of producing new technologies that would benefit other manufacturers. Or certain basic manufacturing industries may not be able to overcome their present difficulties, with all their dislocating effects on workers and communities.

Potential Disadvantages. Probably the greatest drawback of a new financial institution would be its cost and its potential effect on capital markets. Proposals have suggested federally subscribed capitalization ranging from $2 billion to $12 billion, and would give the institution additional authority to raise capital from the public. Capital markets are quite large and could easily absorb a marginal shift in resources. However, as the cost rose, the possibility that the institution would disturb financial markets, misallocate resources, and create inefficiencies would increase significantly.

An additional disadvantage is that such an institution might further politicize the economic system. The danger lies not so much in the agency guessing wrong as in the possibility that its decisions would be a subject of negotiation with special interests. Such a tendency could in time undermine the market foundations of the economy.

Whether or not this appears to be a compelling danger depends on one's view of current policies toward industry. To some, the adoption of a targeted industrial policy would appear to go little beyond the current level of government intervention in the economy. As shown in Chapter III, the government already dispenses a wide variety of benefits to individual firms and industries through trade actions, regulatory provisions, procurement activities, and the like. To these it has added special programs such as those involving Lockheed, Chrysler, and the Penn Central. If all these activities are considered as constituting current policy, then the creation of a new institution need not add to the politicization that already exists if it replaces or rationalizes current programs. Indeed, it could in principle be used to reduce the overall level of benefits as well.

What Would the Financial Institution's Mission Be? The advantages and disadvantages offered by a government financial agency lending to or subsidizing industry may be seen more fully in terms of the mission it might have--such as subsidizing the growth of new or "high-tech" industries or the restructuring of older, basic industries.

--Promoting growth industries. A policy of subsidizing growth industries might help to create jobs and maintain higher levels of output and employment in the future. New or "high-tech" industries often have relatively small firms and employ more workers per unit of investment than their more mature counterparts. To the extent that an industrial policy stimulated the expansion of new industries, it might increase employment. But this would not necessarily help workers displaced from declining industries if the new jobs required different and perhaps higher skills, or if the emerging job opportunities were geographically removed from the older industries.

Promoting growth industries might also help them increase their shares of international markets. This is seen as a defensive measure akin to those taken by other nations--for example, Japan with its electronics industry. It is also justified by the infant industry argument--that government aid can be of benefit in the first stages of an industry's growth. Certainly the U.S. computer and semiconductor industries benefited greatly from military procurement contracts in the 1950s and 1960s.

But such a policy might offer substantial disadvantages as well. First, it is not clear that government intervention is needed to promote growth industries. U.S. venture capital markets, which are the most developed in the world, provide substantial amounts of funds to new firms, which have also been very successful in raising capital through public stock offerings. Moreover, the resources available to U.S. firms may even be sufficient to keep them abreast with subsidized competition from abroad. The much-heralded Japanese supercomputer program, for example, is funded at a level equal to a small fraction of the research budget of International Business Machines (IBM). To the extent that growth industries need aid in research and development, they might be assisted through modifications of current federal programs without large-scale subsidization. Remedies are also available to protect new industries from subsidized competitors abroad.

A major disadvantage of large-scale government subsidies is that the resources must be drawn from some other part of the economy. Subsidies to growth industries are most likely to be at the expense of declining industries, which would intensify the problems of the latter.

Finally, setting up a financial institution to counter the policies of other governments might escalate the level of subsidy on all sides. Global overcapacity in certain industries is a real danger--such overcapacity exists, for example in the ethylene industry, which some governments have chosen to expand. Sometimes changing circumstances can turn an apparent growth industry into a declining industry. The Japanese shipbuilding industry--originally targeted for expansion but subsequently rationalized and reduced in size following the 1973-1974 oil price shock--is a good example of such a reversal.

--Restructuring declining industries. An industrial finance agency might be able to pursue policies that private firms cannot. For example, a difficulty in some basic industries is that individual firms are tempted to keep capacity levels above those suggested by their market shares in case demand should grow. As a result, modernization investments are often diffused across too broad a range of plants and facilities to be fully effective. There is much evidence that this has been the case with steel. An agency concerned with restructuring such an industry would be able to coordinate capacity reductions and modernization programs. It could also enforce the mutual sacrifice necessary on the part of management, labor, and suppliers. This was the role taken by the government in its loan guarantees to Chrysler, and by the Municipal Assistance Corporation in the refinancing of New York City's debt. 5/

The disadvantages of such a mission lie in the tremendous political pressures such an agency would face, as well as its exposure to special-interest appeals. The emphasis of the agency could quickly shift from modernizing industries to preserving them intact. Modernization generally implies closing antiquated facilities, improving productivity, and, therefore, sacrificing some employment as was done at Chrysler, a fairly successful example of a government-industry modernization program where employment is now only half of what it was in the late 1970s. These losses in employment partly reflect automation and other changes that are inherent in improving productivity. Pressures to maintain employment levels could result in subsidies that would not achieve the benefits of modernization, whether measured in terms of productivity or of international competitiveness.

As with policies to promote growth industries, providing financial assistance to declining industries would draw resources from other parts of the economy. It might even deprive growth industries of the capital and labor necessary to sustain expansion.

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5. Felix Rohatyn has discussed this issue extensively. See "The Coming Emergency and What Can Be Done About It," and "Reconstructing America," New York Review of Books, December 4, 1981, and March 5, 1981, respectively.

Whether or not it would add to the politicization of the economy depends, in part, on how current policy is defined. In terms of laissez-faire, such an agency would obviously be obtrusive. But if current policy is taken as including the entire range of federal actions in this area, then such an agency might not represent a major innovation. In the past several years, for example, protection has been extended for basic steel, specialty steel, automobiles, and motorcycles, either through tariffs, quotas, or "orderly marketing agreements" in which other nations volunteer to limit their exports to the United States. Such devices mean a substantial cost to the economy since they raise the prices that U.S. producers receive for the protected goods. Limiting foreign steel, for example, raises the price of domestic steel. If trade actions of this type are considered an inevitable response to the problem of international competition, then substituting direct assistance to an industry might offer real advantages because the financial agency could secure concessions from diverse elements of the industry and bring about changes that would potentially reduce the overall subsidy. On the other hand, if current economic problems are viewed as transitory, then a special financing agency might create new problems by providing an incentive for firms to do so poorly that they would obtain government help. Managers faced with difficult and unattractive choices might opt for government support rather than choosing potentially superior but risky corporate strategies.

A financial institution would also incur two new risks. First, if it undertook the restructuring, promotion, or modernization of an industry, it would inevitably become involved in decisions regarding the location of production facilities. This would represent a new degree of intervention in the economy, since current policy has generally refrained from such decision making. Second, creation of a financial institution would institutionalize government intervention and could lead to such assistance being construed as a political "right." In other words, once a formal program of government assistance for industry was set up, private actors might turn to such assistance more readily than they have in the past.

CONCLUSIONS

An analysis of the claims of the major industrial policy alternatives does not provide a clear solution to the question of what, if anything, should be done. What is clear is that all the options carry as much risk as promise.

It is also clear that the discussion would be made easier if agreement could be reached on the goals of industrial policy. The current debate focuses too much on solutions and not enough on problems and goals. The latter need to be established first before solutions can be sought.

The costs of many of these proposals are hidden or are difficult to quantify. They ought to be made as tangible as possible. Many proposals would assist some industries or sectors at the expense of others. Not all the potential impacts can be foreseen, and it is essential to appraise the potential risks of policies not working out as hoped.

In a 1978 Ministerial Conference on Industrial Policy, the Organization for Economic Cooperation and Development recommended seven desiderata for governments to follow in establishing economic adjustment (industrial policy) programs. The seven rules bear careful scrutiny:

- Action should be temporary and should, whenever possible, be reduced progressively according to a prearranged timetable.

- Such action should be integrally linked to the implementation of plans to phase out obsolete capacity and reestablish financially viable entities, without, however, seeking to raise prices above levels providing an adequate return to efficient producers.

- The cost should be made as evident as possible to decision makers and the public at large. Careful attention should be paid to the cost to consumers of action which raises prices, to the cost to taxpayers, and to the effects of subsidized competition on employment elsewhere.

- Where public funds are being injected into the private sector, it is desirable that private risk capital should be involved.

- Assistance given on a company-by-company basis should be framed so as to provide an incentive for improved management practices, notably by ensuring sufficient domestic and international competition.

- Where the primary objective is to support employment in particular regions or towns, consideration should be given to action that can benefit any eligible company in the area concerned, rather than only those in financial difficulty.

- While recognizing that governments must pay due regard to the interests of national security, care should be taken to see that arguments based on considerations of self-sufficiency should not be misused to justify measures for protection and support. 6/

6. Organization for Economic Cooperation and Development, The Case for Positive Adjustment Policies (June 1979).