

Industrial Policy for a Sustainable Growth Path

Aborode Abdullahi Tunde (Corresponding author)

Ambassadorabdullah0@gmail.com

(+234) (09033024616)

Graduate Assistant

University of Ilorin, Nigeria

Abstract

Industrial policy is back on the agenda and the consensus is that it must be different 'this time' from the past. We redefine industrial policy for industrialized countries as a strategy to promote 'high-road competitiveness', understood as the ability of an economy to achieve 'Beyond-GDP' Goals. 'High-road strategies' are based on advanced skills, innovation, supporting institutions, ecological ambition and an activating social policy. This 'new industrial policy' is systemic, working in alignment with other policy strands and supporting social and environmental goals; it affects the structure of the economy as the whole not only the manufacturing sector. Short-term actions, such as protecting employment in unviable companies, low prices for fossil fuels, or reducing wages in high-income economies are counterproductive. To pursue an industrial policy that targets society's ultimate goals without public micromanagement will be challenging. It could be achieved by setting incentives, particularly those impacting on technical progress (e.g. to make it less labour-saving and more energy-saving), by the use of the important role governments have in the education and research sectors, by greater public awareness and if consumer preferences will call for socio-ecological transition.

Keywords: New industrial policy, climate change, competitiveness, innovation strategy

Introduction

Industrial policy has again become a major issue in industrialized countries. We analyze why this has happened and to what extent a 'new' industrial policy should be different from the old, discredited policy, which often tended to decelerate structural change.

Academic scholars (Rodrik, 2004, Aghion *et al.*, 2011; Aiginger, 2007, 2012) offer concepts of a 'new' or 'systemic' industrial policy, which should be based on new technologies and support society's long-term targets. This rationale for government intervention goes well beyond the traditional market failure arguments, such as monopolies and is based on international externalities and coordination failures.

The U.S. government, the European Commission and the OECD have advocated reindustrialization and industry-oriented 'integrated' policies, since at least the recent financial crisis¹. The European Commission has initiated WWW for Europe, a European research program involving 33 European research teams and supporting to analyze the feasibility of a new path for growth in Europe, based, U.S. economists on social and ecological innovation. In the meantime, U.S. industrial policy is lured by the prospect of cheap energy, which it hopes will together with rising wages in China reduce its large current account deficit.

The U.K., which also has twin deficits in its trade and public budgets, is pondering how to revive its industrial sector. At the same time, the U.K. protects its financial sector, which has been a more powerful job generator than manufacturing in the past two decades. France is undecided whether and how to shelter its remaining industry from globalization, relying either on grand projects, regional innovation centers (core competition) or public-private sector networks, or alternatively fostering employment and new businesses by reducing social charges and corporation tax.

Southern Europe has lost a substantial part of its industrial base and is trying to stop its decline in GDP by revitalizing exports to global markets, but forfeiting its chance to organize 'industrial zones' encouraging start ups and inward foreign direct investment with different administrative rules. An important question is whether industrial policy and climate policy are partners or adversaries. The European Commission started this discussion by moving 'sustainability' (together with 'competitiveness') to the 'centre stage' of industrial policy (European Commission, 2010).

Renewable energy was declared one of the 'enabling technologies'. But Europe also envies the U.S.'s cheap, new energy sources and fears that energy-intensive industries in particular will relocate to the U.S. for lower energy prices, or to Asia for lower environmental standards. These arguments limit the 'greening' of Europe's industrial policy. If the second line of arguments wins, Europe will lose the first-mover advantage of becoming a test-bed for clean technologies, which could be exported to other countries in the future, as worldwide environmental ambitions increase.

Discussion of the challenges of a 'low-road' answers to the U.S.'s new competitive advantage of low energy prices, and contrast it to a 'high-road' strategy for competitiveness. This strategy connects industrial policy proper with innovation and climate policy, to generate a new, 'systemic' industrial policy. It supports society's long-term goals and is based on the comparative advantages of industrialized countries. The alternative, a low-road strategy aimed at lower standards and wages, would bring the similar short-term relief for troubled companies as 'old' industrial policy used to do, reducing the long-term dynamics of manufacturing in rich countries.

Re-Emerging Attention for Industrial Growth

The eventual decline of the share of growth in industrialized countries' GDP is well established in economic theory (e.g. as the second phase of the so-called three sector hypothesis).

It is driven both by demand forces (the preference for services increases with rising income) and by supply forces (technological progress lowers manufacturing cost). This sectorial shift after a first phase of industrialization has been welcomed as a sign of a mature society, because service jobs are less strenuous and subject to less cyclical variation.

It has been argued that this transformation should not happen too soon or too quickly, inter alia because the lion's share of technological innovation occurs in manufacturing. Product-cycle theory and trade theory stress that it is a particular feature of the international division of labor that industrialized countries have advantages in the invention and innovation phase, while developing countries have advantages in manufacturing mature products with standardized production.

The transfer of parts of the value chain to lower-income countries provides rents for higher-income countries. At the same time, services have changed from personal and government services, to 'production-related' services, the crown jewels being IT- and financial services, which offer dynamic employment and higher wages.

Renewed interest

Increasing attention towards the manufacturing sector, and calls to limit or reverse its decline have arisen since 2000 at least for two reasons: firstly, emerging-market countries' inroads into global manufacturing; and secondly, industrialized countries' experience of the impact that bubbles in non-trade related sectors had on the severity and length of the financial crisis.

Competitive pressure from emerging-market countries: industrialized countries are losing market share to emerging-market manufacturers, which are making inroads in ever more sectors, and not only in traditional, labor-intensive ones. China now has the largest industrial sector in absolute terms. Trade deficits of several large industrialized countries have ballooned and can no longer be offset by service exports.

Experience before and during the financial crisis

Economic growth in nonmanufacturing was particularly strong in the run-up to the crisis; bubbles occurred in the construction sector, in property prices and in financial markets, often driven by low interest rates or public support. Evidence has mounted that economic growth is no longer positively affected by the size of the financial sector, as bubbles in finance and construction have destabilized economies (Cecchetti - Kharroubi, 2012).

Looking for indicators to explain different national performance during the Financial Crisis has shown the current account balance as the most important determinant of the depth of the crisis across countries (Aiginger, 2011).

Towards a new growth path: four game changing proposals

However, changes need to go further. Europe must develop its existing socioeconomic model into a role model for a dynamic, inclusive and ecological society in a globalizing world. Social expenditures and ecological ambitions should be turned from costs into drivers of new dynamics (e.g. through an activating labor market policy or an innovation-based sustainability strategy).

A new European model could be attractive for young people, as well as for countries climbing up the income ladder, which are looking for alternatives to the Chinese catch-up model or the U.S. frontier model based on individualism, with low priority for social goals and sustainability.

The European Commission reacting to this need for a new and far-reaching strategy tendered a large socio-economic research program ('WWWforEurope') to develop a new growth path that, on the one hand, extends the goals of Europe 2020 into the future and on the other targets a much deeper socio-ecological transition.

Tentative results indicate that several important changes have to be made, if Europe wishes to develop its socio-economic model into a compelling vision. We start by noting some of the overarching changes needed, then discuss some 'barriers' to change.

Game changer 1: From GDP to beyond-GDP

Economists always understood that GDP is not a welfare indicator – technical reasons and for the concept. GDP and its growth nevertheless dominate the discussion of economic policy and are seen as the single overarching measure of success of an economy or region. The criticism of this indicator and its alternatives were summarised by the so-called Stiglitz - Sen - Fitoussi Commission, leading to the 'beyond-GDP goals' (Stiglitz *et al.*, 2009).

These are now widely accepted as a superior theoretical approach. The OECD has published a corresponding set of 'Better Life Indicators', which many countries now start to use as measure of performance. Income per capita and income growth will remain important goals particularly for low-income individuals, regions and countries. Other goals receive greater priority, as the marginal utility of income declines.

This does not preclude GDP dynamics from remaining an instrument for reaching other ultimate goals, such as full employment, social security, health, consumer choice and so on – the key point is that we should measure the achievement of the ultimate goals, not of the instruments used to reach them.

For a new European growth path and industrial policy, this change from GDP to beyond-GDP is particularly important. The industrial sector is one of the largest production sectors and is responsible for the lion's share of research and development. If the innovations developed in manufacturing do not help attain welfare (as defined by the beyond-GDP goals) the potential of the economic system is not fully utilized.

Industrial policy should enforce and accelerate manufacturing's welfare orientation, should support also non-technical innovation and it should be systemic and forward-looking.

Game changer 2: Redefining competitiveness

The term competitiveness has been used over and over again in the narrow sense of cost competitiveness, calling for lower wages and other production costs as policy instruments to 'stay' competitive or 'regain' competitiveness. In its enlightened version productivity is acknowledged as a second element of cost competitiveness, leading to unit cost approaches.

The cost focus has been criticized for a long time, spawning approaches that emphasize technological or qualitative competitiveness, and measuring 'outcome competitiveness' using a combination of targets (e.g. income, employment). Finally, competitiveness should be based on capabilities like skills, innovation, institutions, an empowering social system and ecological ambitions.

Outcomes should be defined by the achievement of broad, socio-economic goals. Aiginger – Bärenthaler-Sieber - Vogel (2013) therefore propose defining competitiveness as the 'ability to deliver beyond-GDP goals'. This definition could end the preoccupation of economic policy with costs instead of capabilities.

Game changer 3: Distinguishing between a low road and a high road

In principle, countries have two ways to close current account deficits, to increase dynamics of the economy or to reduce unemployment. One is to lower costs (wages, taxes, energy prices); the other is to raise productivity, by boosting capabilities (education, innovation), and by becoming a leader in energy efficiency and renewable energy.

The label of the first path to regain competitiveness a 'low-road strategy' and the second a 'high-road strategy'. It is difficult for countries with high wages to increase per-capita GDP by reducing wages, because low-income countries have greater competitive advantages in this aspect. Industrialized countries can more successfully compete on quality, innovation and new services.

Game changer 4: Industrial policy as a strategy for high-road competitiveness

Academic literature and commentary provide many definitions of industrial policy, without an agreement on a common definition. The proposed to define industrial policy as economic policy to promote the competitiveness of a country or region.

Summary: A systemic policy, aligned with beyond-GDP goals

(1) Industrial policy is back on the political agenda, driven by fear (globalization, deindustrialization) and hope (increasing employment, sustainability). Bubbles in nonmanufacturing sectors (finance, construction, and housing) have fuelled the financial crisis, and recovery is especially difficult in countries with a small manufacturing sector, particularly when it is combined with a current account deficit.

(2) Academia suggests that a new industrial policy must be different from the past. It should promote competition and be a discovery process in a cooperative climate between government and companies. It should align industrial policy with the long term interests of the society.

It has to be systemic and driven by a wider vision, instead of a standalone policy in conflict with other strands of government policy. It should stop extending the life of non-viable industries or artificially creating national champions requiring shelter from global competitors.

(3) A new industrial policy requires three new yardsticks and a redefinition of industrial policy.

First, economic performance should be measured by a broader set of goals or a more comprehensive indicator, instead of GDP (or GDP growth). This could be the 'beyond-GDP goals' or some overall indicator of wellbeing like life satisfaction, happiness or life expectation.

Second, it should downgrade or abandon the concept of price competitiveness, which emphasizes low costs (or in its enlightened version low unit labor costs). Competitiveness should be defined as 'ability to achieve beyond-GDP goals'.

Third, in trying to increase welfare (beyond-GDP goals) countries may pursue a low-road strategy (emphasizing low costs, taxes, social and ecological standards) or a high-road strategy based on research, skills, ecological ambition, an empowering employment policy and excellent institutions. Industrialized countries have to pursue a high-road strategy, if they want to maintain their frontier position. Industrial policy for high-income countries should be defined as the sum of policy measures to achieve 'high-road competitiveness'.

By targeting highroad competitiveness and achieving society's wider aims (including social and ecological goals), industrial policy thus merges into a systemic socioeconomic strategy.

(4) Policy documents developed by international organizations, by the European Commission, and national governments have defined new goals for industrial policy that partially follow the ideas of academia.

All proposals directly or indirectly focus on the structure of the economies as a whole, not only on a narrowly defined manufacturing sector since the borders between manufacturing and services are ever more blurred. The OECD's 'New Perspectives Program' promotes the inclusion of social and ecological goals into economic models and thinking.

(5) The European Commission puts sustainability 'at the centre stage' of industrial policy (unfortunately jointly with a rather conventional defined competitiveness).

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