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Government can't pick the winners

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One of the worst official responses to the financial crisis and recession has been the revival of "industrial policy." Once again, governments are using subsidies, mandates, regulation and capital investment to pick industrial winners and losers, rather than employing a broad, even-handed approach.

The new round of industrial policy is occurring in advanced economies such as the United States and Britain, which long resisted its worst excesses; France, which long promoted national "champions"; and emerging economies such as Brazil and China. French President Nicolas Sarkozy, for example, plans to borrow €52-billion to promote what his government guesses, or hopes, will be "growth industries." Even central banks, especially the U.S. Federal Reserve, have been supporting particular firms and types of assets because of the financial crisis.

Industrial policy appeals to politicians – it allows them to favour key constituencies while claiming to be helping the economy as a whole. But it usually does far more harm than good.

Perhaps the most contentious area of industrial policy is government's role in research and development.

Most markets function best when the returns are received and the risks are borne by private owners, but for basic scientific research, the potential return is broadly available to any and all. Because private investors are unable to appropriate the returns, private markets invest too little in basic science. That's why economists of all political persuasions agree that governments should fund basic science and technology. When I chaired the Council of Economic Advisers for U.S. president George H. W. Bush, we doubled the budget of the National Science Foundation.

However, governments also risk crowding out private R&D, the returns from which could be fully appropriated by private companies, both through their own use and by patenting and licensing the technology to others. The appropriate place to draw the line conceptually is at precompetitive, generic science and technology. Governments should fund R&D until it reaches the stage where private companies can appropriate most of the benefit. It should also remain generic research, thereby maintaining a level playing field for commercial applications.

An example: The computer-linking technology that created the Internet was funded by an agency of the U.S. Defence Department. But it would be foolish for the government to subsidize a particular search engine or social-networking platform. It simply doesn't work, and, worse still, it crowds out or stifles potentially valuable competing technologies.

In the 1980s, advocates praised the extensive use of industrial policy in Japan. But the attempt to micromanage the economy is one reason the Japanese wound up with its "lost decade" – a burst asset bubble, three recessions and the highest public-debt-to-GDP ratio of any advanced economy.

Back then, American advocates of industrial policy – often called "Atari Democrats," after that early maker of computer games – didn't even get their facts straight. While Japan had a "fifth generation" computer project and a scheme to develop HDTV, the vast bulk of its subsidies went not to new technologies, but to old-line, high-employment industries such as agriculture, mining and heavy manufacturing.

Similar economic problems permeate the history of the past few decades, from South Korea to Western Europe to the United States. In 1980, president Jimmy Carter ran for re-election on a platform of "national reconstruction banks," industrial policy and a council headed by labour and business leaders that would decide where to invest tens of billions of dollars. He was trounced by the free-marketeer, Ronald Reagan.

But even in the United States, industrial policy is making a comeback. President George W. Bush spent years and billions of dollars pushing a hydrogen car. It got nowhere, and, while hydrogen may eventually become commercially viable for stationary sources, its use for transportation must still overcome some serious obstacles (including flammability and combustibility that is an order of magnitude greater than that of gasoline).

America's massive \$787-billion fiscal stimulus, ostensibly designed to combat recession and create jobs (but so far ineffective) contained immense sums for subsidies to specific industries and technologies, including nearly \$40-billion for clean-energy programs alone. Firms and investors take the funds, but private financing for commercial alternative-energy projects is already widely available – an immense number of venture-capital funds worldwide are devoted to alternative and clean energy.

Governments should set general goals for energy and the environment and then let entrepreneurs, investors and consumers decide how best to achieve them. It should invest in basic scientific and technological research applicable to these issues. But no policy makes sense if it cannot be sustained without long-term government support.

Whatever the dubious temporary merits of reviving industrial policy in a deep recession, governments need an exit strategy before the programs become permanently entrenched and develop powerful rent-seeking constituencies. Vast amounts of debt-financed spending will require higher future taxes, which will divert capital and labour from higher-value uses than can be sustained without permanent government lifelines.

Industrial policy failed miserably in the 1970s and 1980s. It's just as bad an idea today.

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