Competition Policy vs. Industrial Policy as a Growth Strategy

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Today I would like to compare industrial policy with the competition policy as an instrument of strategies for economic growth.

The **industrial policy** promotes the targeted industries, through trade protection, tax breaks, and government loans. This policy is typically intended to foster innovation in the targeted industries.

It is well known that innovations in cameras, electric appliances, and autos led the post-war Japanese economic growth. We should note, however, that many innovations in Japan took place without the help by industrial policies.

Competition policy, on the other hand, refers to any policy that promotes competition in the market. Thus, anti-cartel policy, trade liberalization, deregulation, and privatization of publicly owned monopolies are included. This policy is designed to promote relocation of resources to high productivity sectors by removing the obstacles that hamper the natural flow of resources into high productivity sectors.

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Along with innovation, reallocation of resources from low to high productivity sectors is an important source of economic growth. In Japan, migration of workers from the agricultural to the manufacturing sectors improved nation's productivity during the rapid growth period. So was the shifting of resources from coal mining to the industries that use low-cost imported oil.

Industrial policy is most popular among companies, politicians, and government officials in many countries. Competition policy is often unpopular among them, because it is against the interests of the firms and industries with strong political power.

Part I: Competition Policy

1. Why competition policy?

If left to the competitive market, resources will flow in the direction of higher productivity, where the rewards are higher. Hence markets allocate resources efficiently. However, this natural flow of resources often faces obstacles set up by incumbent firms to protect their vested interests. The purpose of competition policy is to break up these obstacles.

A remarkable example of competition policy is the tariff-free opening of the Japanese ports in 1859, which was forced by foreign powers on Japan. Domestic cotton growing was completely wiped out in 10 years after that opening. The high growth of the early Meiji Period would not have been possible without such a drastic competition policy.

2. Competition policies in the early post-war period

Competition policy played an important role in stimulating the growth of the post war

Japanese economy. Let us historically review the various competition policies employed during this period.

Dissolution of Zaibatsu (1945 - 50)

First, immediately following the Second World War, the General Headquarters of the occupation force, which was then called GHQ, requested the Japanese government to dissolve the prewar industrial conglomerates known as Zaibatsu. The dissolution of Zaibatsu took place between 1945 - 1950.

Before the war, a small number of conglomerates, including Mitsui, Mitsubishi, and Sumitomo, dominated the Japanese economy. In the eyes of the GHQ, these conglomerates were a driving force for the nationalistic, expansionary government policies leading up to the war. The GHQ considered that these prewar conglomerates should be dismantled, partly because of this perception, and partly because of its well-founded belief that promoting competition provided an essential environment for a healthy economy in Japan, just as in the United States. As a result, the Zaibatsu companies were broken up into several smaller companies, and the shares of the holding companies owned by the Zaibatsu families were virtually confiscated.

Establishment of Fair Trade Commission (1947)

In 1947, the Japanese government enacted the Anti-Monopoly Act, and established the Fair Trade Commission. Following the breakup of the prewar conglomerates, the various sibling companies managed to maintain informal association between themselves. However, they were no longer governed by a single holding company, and these informal groupings were under the strict surveillance of the Fair Trade Commission. The anti-trust policy, initially forced by the GHQ, no doubt laid the foundation for the competitive business environment under which Japan was able to attain the economic growth in the post war period.

Trade liberalization (1960s - present)

The next major competition policy was the drastic trade liberalization policy of the 1960s, which forced Japanese firms to face international competition.

One startling example is the import liberalization of oil. By 1960, Japan was almost self-sufficient in coal. In the late 50s, however, very cheap Middle East oil suddenly became available and to protect the domestic coal industry, the government relied upon import barriers for oil.

In the early 60s, the Japanese government liberalized the import of oil, which effectively dismantled the coal industry, resulting in the unemployment of some 300,000 coalminers.

The rapid economic growth of the 1960s, however, would have been impossible, without the import liberalization of oil.

3. Competitive environment in the early post war period: Overview

It may be pointed out that some of the representative firms in the post war Japan started as venture capital in the competitive environment. For example, Sony was founded in 1946 by two young engineers, Mr. Ibuka and Mr. Morita. Honda Motors was founded by Mr. Honda, who did not go to a collage. Panasonic was founded by Mr. Matsushita who did not even go to a junior high school. These success stories in the early post war period indicate the importance of the competitive environment symbolized by the Zaibatsu dissolution and trade liberalization.

Part II: Industrial Policy

1. Cases for industrial policy

Earlier, I stated that if left to the market, resources will flow in the direction of higher productivity. In microeconomics, this proposition is formally stated as the "**Basic Theorem of Welfare Economics**," which reads as follows: a competitive market mechanism allows efficient resource allocation in the absence of market failures. This theorem is at the base of any competition policy.

This theorem, on the other hand, implies that in the presence of market failures, the government may be justified to intervene with the market.

Industrial policy intervenes with the market. Hence, it can be justified only when a market failure exists, where market failures arise from scale economies, public goods, externalities, and information asymmetry.

Scale economies

The first justification of industrial policy states that an industry subject to scale economies may be protected in the initial stages, through import tariffs, for example. This justification of protection is often called "the infant industry" argument.

If capital market is perfect, however, private investor will find it profitable to invest in such an industry anyway. Government intervention therefore, is not necessary then.

Especially, under the free international capital movement, foreign companies will be attracted to invest in such an industry. So the traditional justification for industrial policy based on the presence of scale economies is untenable in the contemporary environment of global capital movement.

Externalities

The second justification is based on the existence of externalities. If the source of externalities is the spillover effect of technological innovation, however, establishing the protection system of intellectual property right is the appropriate policy. If externalities are caused by agglomeration type externalities, Pigovian subsidies for the activities that produce externalities are appropriate, rather than export subsidies, for example.

Strategic trade policy

The third justification is Krugman's strategic trade policy which is essentially a beggar-thy-neighbor policy, and Krugman himself points out that this nature of this policy may make it difficult to sustain it in the long run. Thus, strategic trade policy is not practical.

We can therefore conclude that none of the conventional justifications of industrial policy is well-founded in practice.

2. Industrial policies in Japan

Until around 1990, however, a common belief was that the source of Japanese economic growth was the industrial policy orchestrated by the Japanese Ministry of International Trade and Industry (MITI) as represented by Chalmers Johnson's 1982 book "MITI and the Japanese Miracle". In reality, most of MITI's industrial policies were ineffective in stimulating growth.

The most blatant example is the government subsidies for the development of the fifth generation computer in the 1970s, which turned out to a fiasco, as mainframe computers became obsolete with the advent of personal computers.

Moreover, Hiroshi Ohashi of The University of Tokyo demonstrated in his 2005 article in Journal of International Economics that the subsidy on the export of steel, the major industrial policy of MITI, had an “insignificant impact on the growth of the steel industry” using his highly respected empirical simulation model. Export subsidies were not the source of the emergence of the Japanese steel industry.

In a comprehensive study of the industrial policy that appeared in Review of Economics and Statistics in 1996, Richard Beason and David Weinstein examined all industries, and concluded that there was no evidence that productivity was enhanced as a result of industrial policy measures, contrary to the conventional wisdom.

3. Growth without government help

Thus, these empirical studies have shown that the industrial policies have been ineffective. Indeed, it is difficult to name successful industries that received help form the government. On the contrary, the representative companies like Sony, Honda, and Panasonic that grew in the post war period received little help from the government.

Indeed, Hirotaka Takeuchi (2005) showed that there was practically no role played by the government in most of the successful industries in the post war Japan. His list of such industries runs as follows: industrial robot, air conditioner, sewing machine, video tape recording, fax machine, audio equipment, car audio, typewriter, camera, carbon textile, tracks, TV games, music instruments, and forklifts.

Part III: Competition Policy vs. Industrial Policy

1. Industrial policy for declining industries

Despite the ineffectiveness, industrial policy has attracted policy makers. That attraction is so strong that industrial policies were carried out even in these industries without the merits of industrial policy. In the aforementioned paper, for example, Beason and Weinstein found that the disproportionate amount of targeting of the Japanese industrial policy occurred in low growth sectors and sectors with decreasing returns to scale. In addition, Noland and Pack (2003) showed that the Japanese industrial policy was mainly focused on agriculture and mining, which do not have international competitiveness.

2. Why policymakers are attracted to industrial policy, then?

A question arises: why are politicians attracted to industrial policy?

They are attracted because beneficiaries vigorously campaign for industrial policy measures, while the opponents do not.

An industrial policy provides deep benefits to a relatively small number of firms, and hence, its beneficiaries have a great political incentive to campaign for its implementation. This implies that government officials and politicians are exposed to the temptation of receiving either explicit or implicit kickbacks from the assisted industries. In Japan, high government officials have often retired into the executive positions of the firms targeted by industrial policies. During the 1960s, the board meetings of the Association of the Steel Industry, which was represented by senior executives of steel companies, were called the board meeting of ex-Vice Ministers of MITI, for example.

The negative effects on an industrial policy, on the other hand, are thinly spread across consumers in the form of slightly increased prices or tax rates. Hence, victims of an industrial policy do not find it worth the cost to campaign against such policies.

This is the reason why industrial policies are popular among politicians and bureaucrats in spite of the ineffectiveness.

3. Choice of growing industries: Government selection vs. Private Initiatives

In an industrial policy, government chooses a target industry. If the promotion of this industry turns out to be a failure, however, no one in the government takes responsibility. After all, tax money has already been spent on the project, or the import prices have already been raised, and the damage from failure is spread widely but thinly among the consumers. Thus, no particular individual will lose any meaningful amount of money. For this reason, the government is not under pressure to examine the cost-effectiveness of the industrial policy prior to its implementation.

This lays in stark contrast to the competition policy under which private investors selects the industries to invest in. Competition policy gives freedom to private companies to invest anywhere they want, but under the condition that the investors themselves lose money if the project fails. Those investors, unlike the government, will carefully examine the cost-effective of the investment before the project is started.

From the viewpoint of the economy as a whole, therefore, the government has a distinct disadvantage in selecting a growth industry in an industrial policy.

Conclusion: More Competition Policy for Growth

1. Industrial policy was harmful to the economic growth of Japan

I have compared industrial policy and competition policy as an instrument for growth promotion strategy. My main conclusion is that there is no intrinsic reason for an industrial policy to be effective in the productivity growth of the protected industry. Indeed, the postwar Japanese experience has verified the theoretical expectation that industrial policy is ineffective.

An industrial policy shifts resources from untargeted industries into the targeted industry, and hence the output level of the former is reduced. Thus the findings that industrial policy measures were not effective implies that the industrial policy was harmful to the economic growth of Japan.

In Japan, the harmful effect was reinforced by the fact that the targets of industrial policy have been chosen with political, rather than economic rationales.

2. Why did Japan grow despite the industrial policy?

The question then arises: why did Japan grow despite the existence of obstructive industrial policies? One of the most important causes is that at the early stage of the post war period, the foundations of competitive policy was set in the form of Zaibatsu dissolution, anti-monopoly policy, and trade liberalization. This is reflected in the fact that many of the venture capital firms of the post-war period became the driving force of the export during the rapid growth period.

3. Why did Japan stop the rapid growth in mid 70s?

The next natural question then is: why did Japan stop growing 40 years ago? By the end of the rapid growth period of the 60s, various industries had accumulated vested interests and started to defend their interests by setting regulations to block new entrants through their influence on politicians and government officials.

Policymakers, however, have been often reluctant to strengthen competition policy as it deeply damages the interests of the incumbents, who usually have stronger political power than the challengers and consumers in general. Thus the Japanese policy makers have been unable to remove bedrock entry barriers in agriculture, fishery, medical industry, and labor.

For example, corporations are not allowed to own farmland, neither are they allowed to independently operate fishery along the coast. Also the numbers of hospital beds are strictly controlled in each city.

In my view, accumulation of these entry barriers are the fundamental causes of the dramatic decline in the growth rate of Japan in the last 40 years.

4. Employment regulation

It should be noted that among the various entry barriers in Japan the entry barriers to the labor market have been the most damaging to the Japanese economy as a whole. Japanese employment regulation practically obligates a company to keep its employee until the retirement age, and hence makes it difficult for a company to dismiss regular employees. This regulation makes the Japanese labor market inflexible by hindering workers from switching employers for two reasons.

First, due to the regulation, dismissal is rare, which makes the openings of mid-career positions scarce.

Second, even when a position is open, a company typically fills it by promoting one of its regular employees to that position. This regulation makes it risky for a company to hire someone with a useful experience for a particular need of time because it obligates the company to keep him even after the need should disappear. Most companies are compelled to hire young person with good general aptitude and flexibility, in order to cope with the unexpected changes of the corporate environment. The regulation gives a company strong incentive to hire most of its workers fresh out of school, rather than an experienced mid-career person.

This regulation is advocated by labor unions of regular employees. It has virtually wiped out the opportunity for non-regular workers to get regular jobs. The regulation makes it hard also for regular workers to switch their employers

5. Lack of venture business

Incidentally, this strict employment regulation makes it very difficult for person to start a new venture company by quitting a large company because he would have no place to go back if he failed. This may explain why relatively few venture companies appeared in the IT industries in Japan when many venture companies emerged in Taiwan successfully collaborating with the Silicon Valley firms during the 1980s.

6. More competition policy is needed for growth.

There have been sporadic attempts to strengthen competition, however.

Influenced by President Regan and Prime Minister Thatcher, Nakasone administration privatized Japan National Railways (1987), Nippon Telegraph and Telephone Corporation (1984), The Japan Tobacco and Salt Public Corporation (1985), and Japan Airlines (1987).

A more recent competition policy was a series of regulatory reforms led by the Koizumi Government in the early 2000s. The purpose of the Koizumi deregulation was to remove entry barriers accumulated during the post-war period.

Politically weak successors of Koizumi, however, were not able to continue the Koizumi reform.

Prime Minister Abe, who has regained the power in 2013, started to promote regulatory reform again, for example, by establishing National Strategic Special Zones. Extensive regulatory reforms have been carried out in medical industry, agricultural industry, and city planning area. But at the same time the Liberal Democratic Party has been implementing new entry barriers in taxi and liquor retail markets.

Whether or not Japan can regain its strength depends on how vigorously it can implement competition policy. I believe that whether an emerging country can maintain its strength in growth also depends on whether it can effectively promote competition policy in the long run.

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