EC330-3-SP – Lecture 12

Industrial and Competition Policy

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Plan of talk

- **Introduction**

1. The theoretical debate over industrial policy
2. Industrial/trade/competition policies during transition
3. Assessing competitiveness of transition economies

- **Wrap-up**

Aim and learning outcomes

- **aim**: discuss the problems in defining industrial policy and its relevance during transition
- **learning outcomes**
  - summarise the debate on industrial policy
  - comment on the experience with industrial, trade and competition policies in post-socialist economies
  - present empirical estimates of the competitiveness of industrial branches at the start of transition

Industrial policy: problems of definition

- **traditional view**, implicit in post World War II policy making
  - *selecting* specific industries as important in a strategic sense
  - *supporting* their performance and competitiveness by government policy
- **more recent views**
  - Geroski (1989): "a wide-ranging ill-assorted collection of micro-based supply side initiatives which are designed to improve market performance in a variety of occasionally mutually inconsistent ways"
  - Caves, Frankel and Jones (2002): "a new label that seeks to embrace trade policy and much more besides"
- **international competitiveness**: at the heart of the debates
  - but shouldn't *market distortions* and *competition policy* be **instead** the appropriate goal of government intervention?…
  - … and **what** *does* international competitiveness *actually mean*?

Krugman (1996), "Making Sense of the Competitiveness Debate" (I)

- **"mercantilists"**: politicians, business leaders and journalists
  - *countries* compete with each other *as corporations* do
  - the *purpose of trade* is to generate exports which *create jobs*
- **"classicists"**: economists following classical trade theory
  - an export is an indirect way to produce an import
  - which is worth doing because it is *more efficient* than producing the imported good domestically
- **"strategists"**: new trade researchers involved in policy
  - the classical trade model *fails* because:
    - competition is imperfect (oligopolies and increasing returns to scale)
    - wages are not equalised across industries
    - there are industries in which technological spill-overs from other national sectors may create exports and, hence, comparative advantage
  - the *government* then should stand behind:
    - industries that can generate future monopoly rents
    - industries that persistently pay higher wages
    - industries that may generate strong spill-overs

Krugman (1996), "Making Sense of the Competitiveness Debate" (II)

- **"realists"**: new trade theorists who are *sceptical* about the *practical* prospects of strategic trade policy, hence of industrial policy in the interpretation above, because
  - potential gains from exploiting imperfections are *very small*
  - strategists' policy recommendations are *often an intellectual cover* for the crudely belligerent ideas of "mercantilists"
- **overall**, Krugman (1996) concludes:
  - "It seems far too cynical to suggest that the debate over competitiveness is simply a matter of time-honoured fallacies about international trade being dressed up in new and pretentious rhetoric. But it is."

Caves, Frankel and Jones (2002): content of industrial and trade policy

can be approached from **two viewpoints**

1. **what welfare economics prescribes:** industrial, as well as trade, policy is *only second-best*, and the optimal (i.e. first-best) policy is to fix whatever causes the underallocation of resources by going directly to the source
2. **what policies governments actually conduct:** a variety of experience but *no theoretical justification* => "sector fetishism"…
   … *unless* when it comes to
   - intellectual property rights (IPRs)
   - or sectors with *non-competitive structures* and *strategic problems* involving both production and trade such as first mover advantages (aircraft industry)
     - high sunk costs
     - strong learning curve effects

     allowing to capture and preserve a (hi-tech) sector that rewards its share of the nation's factor stock more than any alternative use

What should "industrial" policy mean?

- *trade and FDI policy*: encompassed or not?
- *technology policy*: key component?
- **competition policy**: instrument, component or core?
  - addresses issues of *preventing*:
    - monopolies and oligopolies
    - restrictive agreements: e.g. cartels
    - "predatory" practices: problem of defining what is "predatory" behaviour
    - anti-competitive mergers: problem of defining the "relevant market"
  - but can *excessive* competition be ruinous?
  - appears to be the *core* of what "industrial" policy should focus on
  - the *more so in transition economies* due to excessive concentration of industry – in general and by branch – inherited from socialism
- public infrastructure, regional policy, human resources policy,…

Industrial/trade/competition policy during transition

- Audretsch (1995) suggests to view the link between trade and industrial policy from **two perspectives**
  - trade policy as influencing domestic industrial structure
  - industrial policy as promoting the competitiveness of domestic firms
- after transition reforms, **industries** confronted with
  - competitive (or rather comparative) disadvantage
  - higher competition by new domestic entrants and foreign firms

  tended to engage in rent-seeking and lobbying in order to preserve the inherited economic inefficiencies that ensured their jobs and wages…
- … **but** *EU Association Agreements* and *WTO membership* **constrained** policy
  - free movement of goods
  - antidumping clauses
  - converging and adhering to regulations and practices of EU in competition law, company law, banking law, financial services, accounting standards, IPRs, labour and social standards, consumer protection, technical standards, environmental standards, etc…

Transition from plan to market: an "industrial" policy experiment?

- **under socialism and Comecon**
  - extreme "industrial policy" favouring
    - industry over services and agriculture
    - heavy industry over light industry
  - trade administered by
    - internal prices not directly related to world prices
    - artificially maintained exchange rates.
- **with/after the collapse of socialism and Comecon**
  - price and trade liberalisation => drastic change to world prices
  - sharp changes in relative prices of inputs and outputs by branches/sectors
  - gradual strengthening and dominance of those branches/sectors which correspond to revealed comparative advantage in the new conditions
- however, **it takes time to adjust**
  - from the old, rather artificial industrial structure
  - to a market-based one

Hughes and Hare (1992): methodology

concept of **domestic resource cost (DRC)**

- value added in *domestic* prices *divided by* value added in *world* prices
  - value added in *domestic* prices reflects inputs of labour and capital employed by the concerned industrial branch and is *positive*
  - value added in *world* prices represents the contribution of the given branch to GDP measured in world prices
    - where this contribution is *positive*, the corresponding DRC is also positive
    - where the particular branch contribution is *negative*, DRC is also negative
- in **long-run equilibrium**, including an equilibrium exchange rate, an economy's *competitive* branches should be clustered around *DRC = 1*
- the **most competitive** branches are those with *small positive DRC*
- the **least competitive** branches are
  - those with *large positive value of DRC*, meaning that large amounts of domestic resources are required to generate a unit of GDP at world prices
  - those with *negative value added at world prices*: GDP measured in world prices would immediately increase if these branches were simply shut down

Hughes and Hare (1992): estimates

- Table 2, p. 86 in Hughes and Hare (1992): DRCs by ISIC code and country
- Table 6, p. 91 in Hughes and Hare (1992): DRCs in terms of ranks: least (low ranks) and most (high ranks) competitive branches by country
- some interesting **conclusions**
  - no systematic patterns can be discovered, unless perhaps one …
  - … namely, the poor performance of the food industry in all countries
  - the most competitive industrial branches in one country are rarely the most competitive branches in another => complementarity
    - there is little need for EU accession countries to coordinate industrial policies
    - it would be beneficial for these economies to keep on trading with each other
    - there is little risk of Western markets being expected to absorb large volumes of a narrow range of products
  - implicit or *de facto* "industrial policy" in all transition economies
    - *initially*, to avoid rapid closure of loss-making SOEs
    - at *later* stages of restructuring, to shut down those with *negative* value added in world prices and find ways to enhance efficiency and productivity of the *rest* of the firms through privatisation, improving managerial incentives and promoting competition

Concluding wrap-up

- **What have we learnt?**
  - how industrial policy can be defined
  - what its relevance to transition was
  - what constraints in it were implied by EU convergence and WTO membership
  - which industrial branches in post-socialist economies were likely to gain or lose in the transition from plan to market
- **Where we go next**: to the *informal economy* and *labour market reforms* during transition