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INDUSTRIAL POLICY, ECONOMIC GROWTH AND THE COMPETITIVENESS OF U.S. INDUSTRY

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-EIGHTH CONGRESS

FIRST SESSION

PART 3

OCTOBER 31, 1983

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MONDAY, OCTOBER 31, 1983

INDUSTRIAL POLICY, ECONOMIC GROWTH AND THE COMPETITIVENESS OF U.S. INDUSTRY

MONDAY, OCTOBER 31, 1983

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 2253, Rayburn House Office Building, Hon. Dan Lungren (member of the committee) presiding.

Present: Representatives Hamilton and Lungren.

Also present: James K. Galbraith, deputy director; Charles H. Bradford, assistant director; and William R. Buechner, Mary E. Eccles, and Robert Premus, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE LUNGREN, PRESIDING

Representative LUNGREN. Thank you for coming this morning for this hearing of the Joint Economic Committee.

Industrial policy has been roaming the U.S. policy frontier somewhat aimlessly now for 2 years searching for a home. It has been called by one witness before our committee an advertising slogan in search of a product. Someone else has called it a solution in search of a problem.

The Joint Economic Committee has been pursuing this elusive animal for 5 months now. We have held 10 days of hearings. We have learned a great deal. But some say, like all economists laid end to end, we have not reached a conclusion yet.

Today, we would like to get specific. We would like this distinguished panel of witnesses to tell the committee whether or not we should create a MITI-type body to coordinate U.S. industrial policy. I can envision such a coordinating council being involved not only with industrial and technological development, per se, but also perhaps with fiscal, monetary, trade, regulatory, antitrust, and research and development policies to promote the reinvigoration of American industry.

I hope that the witnesses will give us some guidance on this issue. We also seek your comments on the broader issue of industrial policy. Do we need one? Is the United States really going through deindustrialization? What are the bottom line provisions of an industrial policy? Is a Federal industrial coordinating board or coordinating council, or whatever you want to call it, one of the essential features?

We welcome Mr. Charles Schultze of the Brookings Institution, the former Chairman of President Carter's Council of Economic Advisers; Mr. Allan H. Meltzer of Carnegie Mellon University; and Frank A. Weil, former Assistant Secretary of Commerce under President Carter.

Gentlemen, we certainly appreciate your taking the time from your busy schedules to be here, and we look forward to your testimony.

First, I would ask my colleague, Congressman Hamilton, if he has anything?

Representative HAMILTON. No statement. I welcome the witnesses. We are very glad to have you and we look forward to your testimony.

Representative LUNGREN. Mr. Schultze, would you be so kind as to start off, please? Let me just mention at the outset that the prepared statement will be made a part of the record, and you may refer to it or speak from it or proceed as you wish. Thank you.

STATEMENT OF CHARLES L. SCHULTZE, FORMER CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. SCHULTZE. Thank you, Congressman. I will go ahead and try to summarize my excessively lengthy prepared statement, which I gather will be in the record.

I do not have to remind the committee that the last 10 years, throughout the industrial world, has been a time of troubles during which virtually all of the industrial economies, including the United States, measured in terms of growth of employment, of inflation, profits, you name it, economic performance in the last 10 years has been substantially worse than performance in the prior two decades of the postwar period.

The United States, even now, while recovering from the last recession, is suffering from a political impasse over its macroeconomic policies and the combination of very tight money, on the one hand, and very large and growing budget deficits on the other. This combination is giving us a lopsided recovery, with excessively high interest rates and an overvalued U.S. dollar particularly penalizing the long-term growth prospects of the United States and the industries producing investment goods and exports.

These troubles have given rise to several new economic doctrines over the past decade, doctrines and remedies, diagnoses of what is wrong with our economy and prescriptions for its cure.

These new economic doctrines have come not from the economics profession, generally, but from outside the profession. The most spectacular example was supply-side economics which pretty much captured the policymaking apparatus of the U.S. Government based on a huge exaggeration of the legitimate incentive effects of tax reduction.

The latest such doctrine is "industrial policy." It means, apparently, many things to many people. But a growing stream of books and articles have been written on it. The AFL-CIO has endorsed it. And a number of candidates for the Presidential nomination have given it a sympathetic hearing.

What does it mean, industrial policy? Well, it is not a single theory; it is a loose collection of similar diagnoses and prescriptions about the American economy. It starts, I think, with two explicit premises—first, that the United States is "deindustrializing." The manufacturing share of national output is falling. Within manufacturing, our essential heavy industries are in decline and the United States is no longer at the cutting edge in the newer high-tech industries.

We are increasingly becoming uncompetitive in world markets. And according to the advocates of industrial policy, these are symptoms of an internal structural malaise that will not be cured by macroeconomic policy changes, however desirable such changes might, nevertheless, be.

The composition of investment and output in the American economy is wrong, not just its aggregate level. The private market is not allocating investment to the right places. Older, essential industries cannot get the capital or the time to rehabilitate themselves and newer high-tech firms cannot get the capital or cannot afford to undertake the extensive research and development needed to compete in the modern world economy.

As a result, too many of our new workers and too many of our experienced workers displaced from declining older industries, when they do find jobs, find them not in high-wage, high-skill, high-growth industries, but in low-paid, low-skill service industries.

And so, say the advocates of industrial policy, because the private market is not investing to create the right kind of jobs, we are in danger of becoming a nation of hamburger joints, motel keepers, and boutique shops.

There is a second proposition—some other countries, especially Japan, have developed successful government policies to promote vigorous industrial growth. The Japanese Government, working through MITI, identify in cooperation with business leaders and bankers, identify potential winners in advance, encourage their growth, and simultaneously plan the restructuring of, and ease the burdens on, older, declining industries.

Industrial policy advocates, taking these two basic propositions as a starting point, offer a wide range of suggestions as to what we ought to do. Many of those suggestions involve relatively traditional forms of governmental activity in the economy, perhaps in a modified form, like beefed up training programs, more support for research and development, more support for scientific and technical education. And reasonable people can differ about the pros and cons of specific policies along this line, but essentially, that is not new. There is nothing basically new here.

What is new? The major new thrust of industrial policy, based on the diagnoses I have attempted to summarize, is that the Government should set out to create an industrial structure somewhat different from what the market would have created. The Government should become more closely involved in an organized way in the fate of particular firms and industries. The Government should organize itself to change the pattern of investment and output and other resource flows from what the market itself would have produced in accordance with at least a broad strategy of what the shape of American industry ought to be.

Industrial policy thus involves channeling investment to some industries and, I might remind you, necessarily, therefore, away from other industries. The whole point of industrial policy is not aggregate investment, but rechanneling investment, which means minuses as well as pluses.

There are essentially two aspects to this recommendation and there is some disagreement among various advocates of industrial policy as to where the emphasis ought to be. One is concerned with picking successes and encouraging high-growth, high-tech, high-value-added-per-worker industries. The second involves protecting and helping to rehabilitate declining industries.

In addition to the two explicit propositions on which industrial policy is based, namely, America's deindustrializing and secondly, the assertions that other countries, but particularly the Japanese, have a successful policy to avoid this, in addition to those two explicit premises, there are two implicit premises underlying industrial policy.

The first implicit premise is that the Government has the analytic capability to determine, better than the marketplace, which industrial structure is most appropriate, who are likely to be the winners and which of the losers ought to be saved and how should they be saved?

The second implicit premise is that knowing how to do this, our political system is such as to let the Government do it, that our political system can so be set up as to give the Government the freedom to undertake this kind of picking and choosing activity.

In fact, as I want to point out, reality does not square with any of the four premises on which the advocates of industrial policy rest their case. America is not deindustrializing. Japan does not owe its industrial success to its industrial policy. Government is not able to devise a winning industrial structure. And finally, it is not possible in the American political system to pick and choose among individual firms and regions in the substantive, efficiency-driven way envisaged by the advocates of industrial policy.

Let me spend a few minutes on each of these points, and if I run out of time, I will stop in the middle.

First, America is not deindustrializing. Throughout the industrial world, the seventies was a decade of worse economic performance than the sixties, for a lot of reasons. But relative to the industries of other countries, American industry—and by "industry," I really mean manufacturing industry—performed very well by virtually all standards. During the decade of the seventies, before the current recession began, and I will come back to the current period, but during that decade, the United States was unrivaled in producing employment growth. In the United States during that decade, employment grew by 24 percent. The next best was Japan with 9. Germany, often pointed to as an example of successful industrial policy, actually had a decline in employment. That is total employment.

But what is also less well known is that the United States, during the decade of the seventies, was only one of three countries with any kind of increase in manufacturing employment, Italy and Canada being the other two.

Manufacturing output in the United States during the decade of the seventies rose less than Japan, but more than Europe. The share of manufacturing output in our total GNP always rises and falls cyclically. In booms, manufacturing does better than the average and in recessions, it does worse. But adjusting for that, during the decade of the seventies, the share of output, national output taken by manufacturing, did not decline in the United States by any significant amount.

The volume of manufacturing exports in the United States doubled during the seventies, again, less than Japan, but significantly more than Europe.

The United States does have some old line industries in trouble—steel and perhaps to a lesser extent over the long term, but nevertheless, clearly now, automobiles. But this is not typical of the performance of American manufacturing industry relative to the rest of the world.

Indeed, U.S. industry made some very important and desirable and difficult adjustments during the seventies. And at the end of that period, there was no evidence of the inability of labor or other resources to have made the transition from older industries to newer industries.

For example, in 1970, the United States had a trade surplus in high-tech industries of about $15 billion. By 1980, 10 years later, that trade surplus was $40 billion. For all other industries taken together, you just pretty much reverse the signs, going from roughly a minus $12 billion to a minus $35 billion, a major change in emphasis. And yet, at the end of that decade, the number of dislocated workers in the United States, defined to be workers who had jobs in declining industries and who had been out of work for more than 8 weeks, was four-tenths of 1 percent of the labor force.

What about the current situation?

Clearly, in the last 3 years, manufacturing has done worse than the rest of the economy. From 1980 to the fourth quarter of 1982, the trough of the recession, GNP fell by 2.2 percent, and manufacturing production by 10½ percent. But that is typically what happens cyclically in the sense of manufacturing going down more than the rest of the economy. It also recovers faster.

In the last 9 months, while GNP rose in recovery at an annual rate of 7 percent, manufacturing production rose at an annual rate of 18 percent.

Moreover, the misguided combination of very large budget deficits and very tight money has produced an overvalued dollar, which has had a particular downward impact on manufacturing in the last 2½ to 3 years. But this clearly is not due to some structural malaise, but to misalined macroeconomic policies.

What about Japan?

The Japanese do have a way of working together cooperatively, without excessive redtape and without, apparently, dulling the edge of incentives. But the contribution of MITI and Japanese industrial policy to the Japanese industrial success has been far overstated.

One could spend volumes on the subject of economic policy in Japan, but let me just cite what I think is the central point.

There are three major factors, I believe, which fundamentally underlie the Japanese industrial success. First, the Japanese save and invest some 30 to 35 percent of their GNP versus 17 to 20 percent in the United States. Not quite, but almost double.

Second, the Japanese started the postwar period with an industrial plant technologically far behind the United States and other European countries and were able to put those huge savings to work at modest risk and very good return in known directions and in known ways. Countries near the technological frontier, like the United States, have to depend more heavily on the gradual advance of technical knowledge.

And third, the Japanese do, indeed, seem to have a unique cooperative set of labor-management relationships which makes for high productivity and high quality work.

The major decisions about investment in the Japanese economy were not made by MITI, but were made by aggressive, competent business leaders. The main role of government was to provide accommodating and supportive environments. That is not to say that MITI had no influence. The memory chip segment of the world's semiconductor market was importantly penetrated with at least some assistance from MITI. But there have also been some failures. As you know, MITI, for example, tried to keep Honda out of the automobile business and MITI tried to get the Japanese heavily into commercial aircraft, but the banks would not follow MITI's lead.

The advocates of industrial policy seem to suggest sometimes that without the influence of MITI, that huge 30 to 35 percent of GNP which was being invested by the Japanese would somehow have gone into toys, plastic souvenirs, paper products, and fisheries. Well, this is obvious nonsense. Given the nature of Japanese business and Japanese businessmen, it pretty much would have gone where it did, and to the extent it did not, that MITI influenced it the other way, there is no particular reason to believe that MITI did better than what the system would have done without MITI in terms of picking and choosing where that investment went.

Indeed, Phil Treseize at Brookings has looked at the very large investment budget of the Japanese Government, which is a very large amount. And if you look at it in detail, it turns out that those funds went to about the same places as they would in any democracy, very heavily influenced by regional political pressures.

Indeed, if you look at that Japanese investment budget in detail, it looks as if it could have been put together at approximately midnight by a combination of Tip O'Neill, Tom Bevel, Jennings Randolph, and Howard Baker, if I can mix my parties a little bit. [Laughter.]

This concept of concentrating in a highly selective way these funds into a few important winners strongly influencing the course of development is a myth. The combination lying behind Japanese success may now be faltering. In the first place, the Japanese have caught up with the technological frontier pretty well. They have a very high saving rate. They continue to save a huge fraction of their income. But now their investment opportunities, because they are up to the frontier, have shrunk a good bit. There have been two consequences of this—substantially lower economic growth on the part of the Japanese. People do not realize it, but up until 1973, while the Japanese economy had been growing at 10 percent a year, since 1973 it has grown at 3½ percent a year. That is still a little bit better, on the average, than most other countries, but nothing spectacular at all.

And the second thing that has come about because of this huge saving and modest investment is, indeed, a big export push.

Despite the lack of evidence on, one, that the United States is deindustrializing; or two, that Japan, and MITI in particular, owe their success to some kind of industrial policy, the advocates of industrial policy do propose that the U.S. Federal Government play a substantially enlarged role in determining the structure of American industry. And the centerpiece of this is an industrial development bank, a reconstruction finance corporation, or some such agency with some or all of the following authorities—making loans or loan guarantees and subsidized loans to business firms and regional development bodies, certifying eligibility for tax breaks and proposing measures for trade protection, and negotiating restructuring agreements with labor and management in declining industries.

Under most proposals, there would be some kind of tripartite governing or advisory board composed of representatives of business, labor, and the public. And these powers would be exercised in pursuit of at least a broadly defined and explicit industrial strategy to achieve some combination of strengthening the growth of high-tech and high-potential-growth industries and restructuring older industries.

There are essentially two problems for government in pursuing such a policy, quite apart from the fact that it is addressing a problem that does not exist. The first one I talked at some length in my prepared statement about, and I will simply call it to your attention, is that if you look very carefully at the trade structure of advanced industrial countries, it is fairly clear that there are no criteria available to government bureaucrats or anybody else to pick in advance the directions in which a country is going to be successful.

It turns out, when you look at it carefully, that what explains what countries are good at is a combination of historical coincidence and inertia. If you have a good decentralized risk-taking search process, when firms do find a successful niche in the market, as they search for it, you then, at least in some occasions, begin to develop momentum. You develop know-how. You move down the learning curve. Ancillary firms spring up to help supply services and materials to the industry, as a consequence of which countries develop for a while, at least, leadership in areas that you could not pick in advance.

There is nothing, for example, in Swedish national character or natural resources to suggest the Swedes should be preeminent in safety matches, ball bearings, cream separators, and automatic lighthouses. Or the Japanese in motorcycles. Or the United States, just to take an example, in pharmaceuticals and the export of construction know-how.

So my first proposition, therefore, that if you do set this outfit up, there are no criteria to determine it will not be a pork barrel. There are no substantive criteria that you can really put your hands on successfully to identify where growth is going to occur.

Second, there are equally formidable barriers to designing criteria to govern systematic policies for trade preference in order to protect losing industries. As far as I know, no one seriously suggests simply indiscriminate choice. Therefore, there must be some test, some criteria. One test is usually defense. We will protect essential industry. Usually, this is made on an all-or-nothing basis, if we do not do something, we are going to lose our X industry. X normally being steel, but other industries you can insert in place of X.

In fact, that is not the choice at all. What is the choice now, for example, might be something like the following. Right now the steel industry produces 80 percent of our national needs. Without protection, it might get down to 60. Whether it produces 60 or 80 may or may not be important, but has nothing whatsoever to do with national defense.

Another criterion sometimes suggested is that we ought to help industries which other governments are targeting. I cannot think of a more foolish thing to do because, usually, what other governments are targeting are industries with worldwide excess capacity, so if there is anything to make sure that you are putting your money into a losing proposition, it is to follow that criteria.

It is very difficult to suggest such criteria. Even if we had criteria for picking winners or selecting growth firms to encourage and even if we did have criteria to pick firms we ought to protect and support losing industries and how to restructure them, the American political system would not let us do it. And the attempt to do so is likely to inflict harm.

There are many things that the Federal Government can and ought to do, many more than President Reagan seems to realize. And government, if pushed and watched over carefully, can do some of those things passively well. But the one thing that democracies, especially the United States, cannot do well is to make choices among particular firms, municipalities, individuals, and regions, deliberately and cold-bloodedly in an efficiency-oriented sense, which is presumably what you would have to do with an industrial policy if you are substituting government criteria for the market.

And yet, precisely such choices would have to be made.

Government can do harm indirectly. But the essential principle on which the American political system, formal and informal, seems to be based, the Hippocratic oath of American politics is "Never be seen to do direct harm."

We do not administratively make choices among individuals and regions. For example, we have an Economic Development Administration presumably set up to help distressed areas, and by the time it got through the administration and the Congress, the criteria were such that 80 percent of the counties in the United States are eligible. We started out in the Johnson administration with a model cities program testing the idea that you could dump very large amounts of assistance, physical, training, educational, into a selected number of central cities in a large way and break through the vicious cycle of poverty, maybe 10 or 15 cities. By the time it got through the administration and the Congress, there were 150 cities, each with about one-fifteenth of the necessary amount of funds.

We cannot do it. I cannot conceive of an Industrial Policy Board sitting there saying, Youngstown, die. Weirton, stay open. The cotton textile industry is capable of rehabilitating itself and we will help you. The wool textile industry, fold your doors. You steel workers who had a 25-percent premium of wages and fringes over average manufacturing in the late sixties, rose by 1980 to 65 percent above the average. I cannot imagine a Government Industrial Policy Board saying, in addition to "Weirton, stay open" and "Youngstown, die," to the steel workers, "You must give that premium up if the industry is to be competitive."

What I think is more likely to happen is that you would get a back-scratching operation in which declining industries would vote for subsidies for potentially advancing industries in return for votes for protection for the losing industries.

In short, the Government is unlikely to be able to find substantive criteria to develop the policy for a decent investment allocation in this economy and secondly, even if it could, the political system would not help it.

Representative LUNGREN. Mr. Schultze, you invited me to interrupt you at a point and I am sorry, I have to do that.

Mr. SCHULTZE. No, go ahead.

Representative LUNGREN. I want to make sure that we get all witnesses' statements in and have time for some questions.

[The prepared statement of Mr. Schultze follows:]

PREPARED STATEMENT OF CHARLES L. SCHULTZE*

The last ten years have been a time of troubles for most of the world's industrial economies. The growth of output and productivity has slowed. Both inflation and unemployment have averaged substantially higher than in earlier postwar years. And the decade has produced the two worst recessions of the postwar period. At the present time, the United States, while enjoying a recovery from the latest recession, is faced with a political impasse over its macro-economic policies. The combination of huge and growing structural deficits in the federal budget, combined with a tight monetary policy, is producing a lopsided recovery characterized by very high interest rates and a substantially overvalued U.S. dollar. As a consequence, the prospects for long-term economic growth have been reduced and American industries producing exports and investment goods have been especially penalized.

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* The views expressed are my own and are not necessarily those of the officers, trustees, or other staff members of the Brookings Institution.

In the United States, this experience has spawned several new economic doctrines, each purporting to explain the source of at least some of our economic ills and offering a plan of action to deal with them. These economic theories originated outside of the mainstream of the professional economic thought. Perhaps the best-known of them is supply-side economics, which is based on a vast exaggeration of the incentive effects of lower taxes. It has had a spectacular political success, and was installed in early 1981 as official U.S. government policy.

The latest entry in the competition for the hearts and minds of political candidates is a set of economic ideas and policy recommendations that goes by the name "industrial policy." It has been the subject of a growing stream of books and articles, and has found a place in the economic programs of many of the candidates for the 1984 Democratic presidential nomination.

The phrase "industrial policy" means somewhat different things to different people; it refers not so much to a single theory as to a loose collection of similar diagnoses and proposals. The diagnoses generally cluster around two basic propositions:

<u>First, the United States has been "de-industrializing</u>." The share of national output generated by manufacturing has been falling in recent years while the share attributable to services has been growing. Within manufacturing a number of essential heavy industries are in absolute decline, and the United States is no longer at the cutting

edge of technological advance in the newer, high-tech industries. We are becoming increasingly uncompetitive in world markets. These are the symptoms of deep-seated structural problems; they will not be cured by macroeconomic measures aimed at overall economic growth. The private market is not directing investment to the right places; older manufacturing industries cannot find the funds they need to rehabilitate themselves, and promising new firms in the advancing sectors are often unable to secure as much venture capital as they need for growth. American labor finds it difficult to make the necessary transition from older, declining industries to newer ones with good growth potential and high value-added per worker; this is partly because investment is being directed to the wrong industries and partly because laid-off workers do not have the skills needed or are not in the right locations. And when these dislocated workers eventually do get reemployed it is too often in low-paid, low skill service jobs with low skill requirements and low salaries. We are in danger of becoming a nation of hamburger joints and boutique shops.

Second, some other countries — Japan being the preeminent example — have developed governmental policies that successfully promote vigorous industrial growth. The Japanese government identifies potential winners in the competition for world markets and encourages their growth, while simultaneously protecting and easing the burden of adjustment for older but essential heavy industries. Farsighted officials in the Japanese Ministry of International Trade and Industry

(MITI), working closely with cooperative Japanese business leaders and bankers, plan and organize, years in advance, such industrial achievements as the penetration of world automobile markets, the development of automated steel mills producing at water's edge for exports, the 256K memory chip, and now the ultimate super computer.

The various proponents of industrial policy offer a wide range of suggestions to deal with the structural problems they identify. Many of their proposals involve new or modified federal initiatives in traditional areas: expanded support for technical education, research and development, and programs to retrain workers. Whatever the merits of these ideas, they do not constitute a major new thrust in economic policy. What is new, however, is the proposal that government deliberately set out to plan and create an industrial structure, and a pattern of output and investment, significantly different from what the market would have produced. Two leading advocates of industrial policy, Ira Magaziner and Robert Reich, put the matter this way: "We suggest that U.S. companies and the government develop a coherent and coordinated industrial policy whose aim is to raise the real income of our citizens by improving the patterns of our investments rather than by focusing only on aggregate investment levels."[1]

Industrial policy thus aims to channel the flow of private investment towards some firms and industries — and necessarily, therefore, away from others. The government develops, at least in broad outline, an explicit conception of the direction in which industrial structure ought to be evolving, and then adopts a set of tax, loan, trade, regulatory, and other policies to lead economic activity along the desired path.

Industrial policy typically has two aspects — "picking the winners" and "protecting the losers" — and proponents sometimes disagree as to the relative emphasis to be placed on each. "Picking the winners" involves identifying industries that are at the cutting edge of economic progress, with such characteristics as high growth potential and high value-added per worker, and then providing investment subsidies, research support, and other assistance to existing firms and new entrants in those industries. "Protecting the losers," on the other hand, involves supporting and presumably helping to rehabilitate major declining industries. The government measures that would be deployed for this purpose include creation of barriers against competition from imports, special tax breaks, subsidized loans, and selectively favorable regulatory treatment. In most versions of industrial policy, the government, in a switch from current practice, would require that labor and management in these declining industries accept major reforms — wage restraint, reduction of featherbedding rules, and improved managerial practices — as preconditions for assistance.

In addition to the two explicit propositions noted above — that America has been de-industrializing and that the government of Japan has successfully managed industrial adjustment — there are two implicit premises on which the case for a U.S. industrial policy rests. The first of these is that the government has the analytical capability to determine with greater success than market forces what industrial structure is appropriate, who the potential winners are, which of the losers should be saved, and how they should be restructured. The second is that the American political system would (or could) make such critical choices among firms, individuals, and regions on the basis of economic criteria rather than political pressures.

In fact, as we shall see, reality does not square with any of the four premises on which the advocates of industrial policy rest their case. America is not de-industrializing. Japan does not owe its industrial success to its industrial policy. Government is not able to devise a "winning" industrial structure. Finally, it is not possible in the American political system to pick and choose among individual firms and regions in the substantive, efficiency-driven way envisaged by advocates of industrial policy.

De-industrialization: A Nonexistent Trend

America has not been de-industrializing. Throughout the industrial world, economic performance in the 1970s did fall behind the record of the 1960s. But relative to the industries of other countries, American industry performed quite well by almost all standards.[2]

During the decade of the 1970s, before the current recession began, the United States was vastly superior to the major European countries and to Japan in the generation of new jobs. Total employment grew by 24 percent in the United States during that decade. The next best performer was Japan, with a 9 percent increase. Other countries were far behind; in Germany, for example, employment actually fell. Moreover, the United States was one of only three major industrial countries — Italy and Canada having been the others — with any increase in manufacturing employment. According to OECD data, manufacturing production in the United States, while rising less rapidly than production in Japan, grew faster than the European average and outstripped the gains made in Germany, a country that is usually mentioned, along with Japan, as a leading example of industrial strength.[3]

Manufacturing production in the United States typically rises more in business cycle expansions, and falls further in contractions, than does total GNP. After adjustment for this regular cyclical pattern — and contrary to popular impression — there was no significant decline in the share of private domestic GNP produced by manufacturing industries during the 1970s.[4] The proportion of total U.S. employment accounted for by manufacturing has been falling throughout the postwar period, but this principally reflects the fact that productivity growth (output per person) has continued to grow faster in manufacturing than in most other parts of the economy.

The relatively good performance of the industrial sector in the 1970s was partly due to a very large increase during the decade — in fact, a doubling — in exports of American manufactured goods. This was a good bit less than the rise in Japanese exports, but substantially higher than the increase experienced by Europe. America's export strength was aided by a decline in the real exchange value of the dollar, from an overvalued level at the beginning of the decade to what many people believed was a somewhat undervalued level at the end. Since it is unlikely that the value of the dollar will fall steadily over the long run, the share of U.S. economic activity accounted for by the manufacturing sector could conceivably decline very slowly. That would be a natural development, however, in no way reflecting a structural malaise requiring new governmental policies.

The United States does have some old-line heavy industries with deep-seated structural problems — the steel and automobile industries, for example. But they are not typical of American industry generally. There is no evidence that in periods of reasonably normal prosperity American labor and capital are incapable of making the gradual transitions that are always required in a dynamic economy, as demand and output shift from older industries to newer ones at the forefront of technological advances.

Indeed, American industry successfully made some important and desirable structural adjustments in the 1970s, even though that was a decade of economic difficulties throughout the world. Thus, Robert

Lawrence of Brookings reports that the U.S. international trade surplus in the products of high-tech industries grew from $12 billion in 1972 to $40 billion in 1979, while the trade deficit in other manufactured products rose from $15 billion to $35 billion over the same period. Yet, according to a study done for the National Commission for Employment Policy, dislocated workers — defined as unemployed people whose last jobs were in declining industries and who had been out of work for more than eight weeks — amounted to only 0.4 percent of the labor force in March, 1980.[5] In addition, although the total unemployment rate was higher in the United States than in most large European countries as the 1970s drew to a close, long-term unemployment was substantially lower.[6]

But even if it is true that the United States was not de-industrializing in the 1970s, has not the industrial sector performed very much worse than the economy in general during the past several years? Yes, it has. From 1981 through the fourth quarter of 1982 -- the trough of the recession — GNP declined by 2.2 percent while manufacturing production fell by 10.6 percent. But the outsized drop in industrial production occurred for two reasons having nothing to do with de-industrialization. First, as noted above, industrial production always falls faster than GNP during recessions, and rises faster during booms. In the first three-quarters of 1983, for example, as GNP began to recover at a 7 percent annual rate, manufacturing production jumped up at an 18 percent rate. Second, the huge rise in the real exchange value of the dollar over the last two years discouraged U.S. exports and encouraged foreign imports — a development that had an especially depressing effect on American manufacturing industries. But the overvaluation of the dollar was obviously not caused by structural deficiencies in American industry; it was principally the result of the combination of tight money and loose budgetary policy that gave us unprecedentedly high interest rates. What is needed is a better mix of macroeconomic policies, not a new government agency to influence the pattern of industrial investment.

What about the dramatic fall in the rate of productivity growth in the United States during the 1970s? Does that not reflect, at least in part, a major structural problem in U.S. manufacturing sector? The pace of productivity growth did, indeed, decrease. While the reasons for this decline are still something of a mystery, a few things are known. First, the decline was worldwide — and its magnitude in the United States was about midway down the list of industrial countries. Second, the decline was not concentrated in manufacturing industries; in fact, by most estimates it was somewhat smaller there than in the other sectors of the economy, and productivity growth has continued to be higher in manufacturing than in most sectors. Third, the decline was not caused by a shift in production away from high-productivity manufacturing industries to low-productivity service industries.[7]

Productivity growth is the source of rising living standards. The sharp decline in that growth, in manufacturing and elsewhere, is the most serious long-run problem facing the U.S. economy. But there is no evidence that this decline stems from a tendency for the private market system to allocate investment to the "wrong" places — away from the manufacturing sector or, within manufacturing, to the wrong firms or industries. The decrease in productivity growth in no way bolsters the case for an industrial policy.

A Closer Look at the Japanese Success

The postwar flourishing of Japan's economy is frequently cited as the premier example of how successful an industrial policy can be. The Japanese do have a way of working cooperatively towards national economic objectives without getting strangled in bureaucratic red tape or dulling competition among business firms. But the contributions of MITI and of industrial policy to Japan's postwar success have been far overstated. Other factors were primarily responsible for the phenomenal growth that the Japanese economy enjoyed until very recently.

First, over the past two decades, the Japanese saved and invested some 30 to 35 percent of their GNP, compared to 17 to 20 percent in the United States.[8] Second, with an industrial plant technologically far behind those of the United States and Western Europe, Japanese business firms were able to put the huge savings to work at moderate risk and with good returns by upgrading their capital stock with known technologies. Countries that were much nearer to the technological frontier, like the United States, had to depend more heavily for their economic growth on the gradual advance of technical knowledge. Third, the Japanese appear to have developed a unique set of cooperative labor-management relationships that promote high quality work and rapid productivity growth.

Throughout the postwar period, the Japanese government in general, and MITI in specific, did act on a broad view of what was required for rapid economic growth in the particular circumstances facing Japan. For example, private savings and investment were encouraged by tax laws and other measures. Up through the early 1970s, macroeconomic policies were highly expansive, but with a combination of very stimulative monetary policies and large budget surpluses. Thus, the government endeavored to encourage the rapid expansion of both demand and supply. Since it needed to import virtually all of its fuel and raw materials, Japan discouraged the import of manufactured goods. Especially in the earlier part of postwar history, when it was still lagging behind other major countries in industrial technology, Japan protected large segments of its home market against import competition.

But while a broad strategy along these lines did guide Japanese economic policy during the postwar period, that strategy did not dictate the detailed structure of Japanese industry. The major decisions about where funds would be invested were made by Japanese business leaders, not by MITI. Hugh Patrick, professor of Far Eastern economics at Yale, has put forward this assessment:

> Indeed, looking at Japanese industrial development as a whole in the postwar period, I think the predominant source of its success was the entrepreneural vigor of private enterprises that invested a good deal and took a lot of risks. The main role of the government was to provide an accomodating and supportive environment for the market, rather than providing leadership or direction. Unquestionably government planning bodies were important in a few industrial sectors, but not in many others, which flourished on their own.[9]

The Japanese government, through its Fiscal Investment and Loan Program (FILP), does control substantial investment sums, amounting in 1980 to some $80 billion in direct investments, subsidized loans, and loan guarantees. Such a large investment budget does seem to offer potential leverage for carrying out an industrial policy. In fact, however, as Brookings' Philip Trezise carefully documented in the Spring, 1983, issue of the Review, the government's investment portfolio is spread across a wide range of enterprises in response to regional, political, and special interest pressures. In 1979, the FILP budget was allocated among some fifty separate agencies, plus a number of local governments. The local governments, together with four agencies (a housing loan corporation, two small business financing entities, and the Japanese National Railways), got a total of 60 percent of the funds. Another 27 percent went to such entities as the Ex-Im Bank; the Japan Highway Corporation; the Japan Housing Corporation; the Agriculture, Forestry, and Fisheries Corporation; and the Japan Development Bank.

The Japan Development Bank (JDB), in turn, seems a likely candidate for the role of financing an industrial policy aimed at building up major growth industries. The facts belie this conjecture, too. In the first twenty years of the JDB's life, according to Trezise, three-quarters of its funds went to merchant shipping, electric utilities, and regional and urban development. The burgeoning steel industry, on the other hand, received during these two decades less than one percent ($110 million) of the JDB's financing. Since 1972, in Japan as in the United States, public investment has emphasized energy and pollution control — and the JDB budget reflects this trend. But JDB investment in the development of new technologies outside of the energy industry has averaged only $313 million a year over the past decade.

Thus, in Japan as in any other democratic country, the public investment budget has been divvied up in response to diverse political pressures. It has not been a major instrument for concentrating investment resources in carefully selected growth industries. Indeed, if one changed the institutional labels, the Japanese government's investment budget looks remarkably like what might have emerged from a House and Senate conference committee on public works in the United States Congress.

All of this is not to suggest that MITI had no influence on the direction of Japanese industrial investment. For example, MITI is widely, and probably quite correctly, cited as having played a major role in organizing the very successful Japanese penetration of the memory chip segment of the world semiconductor markets. As Paul Krugman has pointed out, however, the relevant question is whether this particular use of Japanese savings generated a higher return for the nation than would have been earned had the market allocated the funds.[10] It may have done so, but we do not yet know the answer.

MITI has also had some major failures. For instance, MITI tried very hard -- and, as is evident, to no avail -- to keep Honda out of the automobile business and to consolidate Japanese auto production into a few giant companies. MITI also attempted to get a major commercial aircraft industry going in Japan, but the banks failed to follow MITI's lead and would not provide the necessary capital. Those who attribute Japan's economic success principally to MITI's industrial policy seem to be suggesting that without MITI the huge 30 to 35 percent of GNP that the Japanese invested in the past several decades would have gone mainly into such industries as textiles, shoes, plastic souvenirs, and fisheries. This is sheer nonsense. Given the quality of Japanese business executives, those massive investment funds probably would have wound up roughly where they actually did. And to the extent that there would have been differences, there is no reason to believe that MITI's influence, on balance, improved the choices in any major way.

The combination that worked so well for Japan — a huge saving rate, aggressive business leaders, and a backlog of modern technology waiting to be exploited — may now be faltering. In particular, as Japan has caught up to the technological frontier of other Western countries, the potential for large returns from investment in known technologies has been reduced. The propensity to save remains high, but investment opportunities appear to have dwindled. Partly for this reason, Japanese economic growth, while still above that in other advanced countries, fell from an average of 9.9 percent a year between 1960 and 1973 to 3.5 percent a year between 1973 and 1983.[11]

Identifying the "Right" Industrial Structure

Despite the lack of evidence that the United States has been de-industrializing or that the key to Japan's economic success has been its industrial policy, advocates of an industrial policy for the United States nevertheless propose that the federal government play a much enlarged role in determining the structure of American industry. The centerpiece of an industrial policy is some kind of a development bank

— a new Reconstruction Finance Corporation — with authority to do some or all of the following: provide loans, loan guarantees, and subsidies to business firms and regional development bodies; certify firms as being eligible for special tax breaks; recommend measures to protect domestic industries against competition from imports; and negotiate restructuring agreements with labor and management in firms and industries that are in trouble and are candidates for assistance. In many versions of industrial policy, the new RFC would be governed, or at least be advised, by a tripartite body made up of representatives from business, labor, and government. The powers of the Corporation would be exercised in pursuit of explicit industrial objectives designed to achieve some combination of the two broad goals — stimulating the emergence and growth of new high-tech industries and protecting and rehabilitating older industries.

The first problem for the government in carrying out an industrial policy is that we actually know precious little about identifying, before the fact, a "winning" industrial structure. There does not exist a set of economic criteria that determine what gives different countries preeminence in particular lines of business. Nor is it at all clear what the substantive criteria would be for deciding which older industries to protect or restructure.

Originally, comparative advantage and international specialization among countries were thought to derive principally from the relative abundance or scarcity of the factors of production — labor, capital, and various natural resources. The United States and other advanced industrial countries do in fact have a broad advantage in the production of those goods that are research-based and technologically sophisticated, and that require for their production an educated labor force. It is also demonstrably the case that the availability of certain kinds of natural resources can play an important role in determining comparative advantage. But beyond these very broad principles, there are no general criteria that allow one to predict the industries in which a country will be particularly successful.

Advanced industrial countries both export and import a wide range of goods that covers almost the entire spectrum of their manufacturing industries. Exports are not concentrated in one set of selected industries and imports in another. One study has shown, for example, that in major countries very few industries, classified at a medium (three digit) level of detail, had less than 30 percent of their international trade as <u>intra</u>-industry trade — i.e., in most categories of industrial goods, international trade involved significant volumes of <u>both</u> exports and imports, rather than exclusively one or the other. The distribution among advanced nations of the production of various manufactured products is not principally a function of some broad set of national characteristics, but arises in large part from quite different causes.

In an insightful article on industrial policy, Assar Lindbeck of the University of Stockholm has analyzed the origins of industrial specialization among advanced countries.[12] He argues that what a country will specialize in is determined by a combination of historical coincidence and momentum. Individual entrepreneurs search for a niche in the market. Once one or more firms in a country successfully establish a foothold in the market for some special product, forces come into play that can heighten, at least for a while, that country's comparative advantage in the manufacture of that product. A growing market leads to economies of scale for the original producers. Ancillary firms spring up to supply the new industry's special needs. Workers and managers acquire skills and know-how. Success tends to breed success.

In short, the winners emerge from a very individualistic search process, only loosely governed by broad national advantages in relative labor, capital or natural resource costs. The competence, knowledge, and specific attributes that go with successful entrepreneurship and export capability are so narrowly defined and so fine-grained that they cannot be assigned to any particular nation. The "winners" come from a highly decentralized search process, the results of which cannot be identified on the basis of abstract criteria. As Lindbeck points out, there is nothing in Swedish natural resources or national character that would have foreordained that Sweden would be preeminent in the production of ball bearings, safety matches, cream separators, and automatic lighthouses. Nor, I might add, is there a basis in observable national characteristics to have predicted Japanese dominance in the motorcycle industry or the American success in pharmaceuticals and the export of construction management and design.

There are, of course, overall policies that government can pursue to create the kind of environment in which a decentralized search process is most likely to be fruitful. What government cannot do — except perhaps in a country that is far behind the leaders and simply trying to catch up by imitating them — is to identify in advance the particular lines and products in which its country will be successful.

Some have argued that a new industrial policy should particularly seek to reallocate investment towards industries with high value-added per worker and away from those with low value-added. The argument for such a reallocation implicitly assumes (1) that there are large numbers of skilled American workers trapped in low-paying jobs in industries with low value-added per worker; (2) that there are large untapped markets for the products of high value-added industries employing skilled workers; and (3) that this situation exists because of a propensity on the part of American business to invest too much in the low value-added, and too little in the high value-added, industries. Government policies designed to improve the skills of the labor force make good sense. But given the current mix of skills in the labor pool, there is no evidence that market forces in the United States have tended to ignore potentially large returns in industries with high value-added per worker and to channel excessive investment to those with low value-added. Indeed, as Krugman points out, government redistribution of a fixed aggregate investment from low value-added to high value-added industries would tend to lower employment and output, since capital-labor and capital-output ratios are higher in the latter industries.[13]

There are equally formidable barriers to designing substantively defensible criteria to govern a systematic government policy of trade protection and investment assistance for declining older industries. No one seriously suggests a policy of indiscriminate aid to all such industries, so some criteria for choice are necessary. One litmus test that is proposed is the importance of an industry to the national defense; that, however, is almost always a red herring. The national defense/essential industry argument is usually presented in an all-or-nothing mode, as though, in the absence of import protection, the affected industry would disappear. In fact, what is almost always at stake is a much less dramatic change in the industry's fortunes, of a magnitude that is irrelevant to national defense. Whether, for example, the domestic steel industry meets 80 percent of the nation's peacetime needs, as it does now, or only 60 percent is of no significance to the nation's security.

It has also been suggested that we assist those particular older and troubled industries that other governments are heavily subsidizing. The industries we would end up supporting under this decision rule would most likely be those with worldwide excess capacity, in which the returns to investment are unusually low, since those are the ones most apt to be getting help from other governments. A systematic reallocation of investment away from other American industries towards these would lower the growth of national output and real wages.

Ironically, the systematic provision of import protection to various industries, in an effort to "restructure" them, would indirectly weaken the most dynamic and progressive sector of American industry. Import protection would initially worsen the trade balances of the countries against whom it was directed. As a result, their currencies would tend to depreciate against the dollar. In turn, this would impair the competitive position of American export industries, which, by their very nature, are likely to be at the leading edge of economic progress. We would trade jobs and output in the leading sectors for jobs and output in the losing sectors.

In practice, the motivation behind most existing efforts to protect the losers is not so much to improve economic performance as to lessen the pains of economic change. Almost by definition, a dynamic economy is one in which change is continually at work — change in technology, in tastes, and in world markets. And while change creates new opportunities, it also forces some firms, workers, and communities to make painful adjustments.

A decent concern for the human costs imposed by economic change is one hallmark of a compassionate society. But society can act to reduce those costs in two quite different ways. First, it can short-circuit market forces and try to slow the pace of change through subsidies, trade protection, and regulations designed to prop up declining firms. Second, it can attempt to accommodate and ease the transitions dictated by changing economic conditions through the provision of reasonable unemployment compensation, relocation assistance, and generous training opportunities to those facing major adjustment problems. Neither approach will fully insulate workers and communities from the pains of economic change. But systematic application of the first approach, while preventing some pain for some people, will over time sap the economy of dynamism and hold down growth in living standards. The second option is far from perfect, but it offers the potential of reducing transition costs with much less impairment of the dynamism that generates economic growth.

Industrial Policy and the American Political System

Not only would it be impossible for the government to pick a winning industrial combination in advance, but its attempt to do so would almost surely inflict much harm.

There are many important tasks that only governments can do — and, with constant effort and watchfulness, they can do those tasks passably well. But the one thing that most democratic political systems — and especially the American one — cannot do well at all is to make critical choices among particular firms, municipalities or regions, determining cold-bloodedly which shall prosper and which shall not. Yet such choices are precisely the kind that would have to be made — and made explicitly — for an industrial policy to become more than a political pork barrel.

The government can, and continually does, adopt policies that have the indirect consequence of harming particular individuals or groups. But a cardinal principle of American government is "never be seen to do direct harm." The formal and informal institutions of the political system are designed to hinder government from making hard choices among specific individuals, rewarding some and penalizing others. So it is, for example, that we have an Economic Development Administration, created to help "depressed areas," that has eligibility criteria so broad that they encompass over 80 percent of the counties in the United States. The same pattern — that of obviating the necessity of choice — is evident in the evolution of the Model Cities Program. Two decades ago, planners in the Johnson Administration set out to test the proposition that a very comprehensive assistance program — directed at physical capital, education, retraining, social services, and so on — that concentrated large investment in a few areas could overcome the inertial force and vicious cycle of inner city poverty and decay. A demonstration of this approach was initially designed to be carried out in a very limited number of cities; hence the name "Model Cities

Program." By the time the concept had made its way through the political thickets of the administration and the Congress, the Model Cities Program encompassed one hundred and fifty cities, each receiving only a fraction of the funding needed.

It is not surprising that the American political system is seldom capable of making express choices among individuals, firms, or regions. The American government, after all, was not established to bring order and authority out of social chaos. Quite to the contrary, it originated in an effort to reduce what was seen as too much authority on the part of the British king and parliament. Its founders were principally concerned to constrain legislative and executive authorities so that they could not make arbitrary and invidious choices among individuals. In the American system, most decisions that discriminate among specific citizens and firms are reached through litigation in the courts, where "fairness," rather than "efficiency," is the major criterion for setting disputes. When it is necessary to permit executive officials to make such decisions, their exercise of discretion is hedged about by complex procedural safeguards, including the right of appeal to the courts. The Administrative Procedures Act, which governs the exercise of regulatory authority, is a prime example of this approach.

The governmental choices that an industrial policy contemplates have little to do with fairness and much to do, at least ostensibly, with exacting economic criteria. As we have seen, these are precisely the sorts of decision that the American political system makes very poorly. A new RFC would do not better. For every twenty new entrants into the high-tech race, nineteen will probably perish and only one succeed. But the federal government's portfolio would likely carry all twenty forever.

To be anything more than a universal protector of inefficiency, a systematic program of assistance to declining industries would have to call for some very hard-headed decisions among particular firms, cities, and groups of workers — that the Youngstown plant can live but the Weirton one must close, for example, or that the cotton textile industry has a reasonable chance to rehabilitate itself but the wool textile industry is a hopeless case and must die. Or that in order for the steel industry to compete successfully in world markets, the large increases over the last fifteen years in its wages and fringe benefits relative to those the rest of industry must be eliminated. Quite apart from the inability of any staff to make such substantive calls correctly, can anyone seriously imagine an American RFC being left alone to make such decisions, with its authorizations and appropriations controlled by the Congress and its policies supervised by a President interested in his own and his party's political success? Rather, we can expect a combination of patterns to emerge: Some assistance would be made available, on a formula basis, to all industries that were in trouble; the wheels with the loudest squeaks might get a bit of extra financial grease; and protectionist interests would have a new and highly vulnerable pressure point to exploit. In the process, resources would be misallocated, incentives for industrial efficiency reduced, and competitive forces blunted.

The False Allure of "Coordination"

One of the most frequently heard arguments for industrial policy is that it would bring a much-needed coordination to government policy-making. Those who make this argument begin by pointing out that the government already has in place many individual tax, trade, regulatory, and subsidy polices that importantly influence the fortunes of particular industries. The automobile industry, for example, is strongly and differentialy affected by the federal government's environmental and safety regulations, by the depreciation and investment credit provisions of its tax code, by the way its anti-trust laws are written and interpreted, and in a very major way by its international trade policies. These policies are carried out by a number of different government agencies without any consistent strategy with respect to their effect on the industry concerned. More broadly, say the advocates of industrial policy, the government has a host of individual policies that affect the nation's industrial structure, often in illogical, contradictory, and harmful ways. They go on to ask why we do not coordinate these existing activities within the framework of a comprehensive industrial strategy.

It is difficult to be against "coordinations—that is like being against motherhood. Nevertheless, when the concept is carefully examined, most of the allure of "coordination" disappears as a rationale for industrial policy. Indeed in some respects, coordination of existing government activities, in furtherance of a centrally devised industrial strategy could be positively harmful.

There are two principal types of federal policies which influence the fate of particular industries.

First, there are a number of legitimate and important governmental programs addressing major national objectives which significantly affect particular industries. Controlling environmental pollution has a much larger impact on the automobile industry than it does on the semi-conductor industry. A rapid buildup in the nation's stockpile of strategic weapons is obviously more important to the aerospace industry than it is to the textile industry. The object of the policy is not primarily to help or to harm particular industries, but to achieve quite separate national objectives. The industrial impacts are the side effects of policies carried out for quite other purposes. The military and civilian programs of the federal government should, of course, be adopted after a consideration of both their benefits and their costs. But we should not as a matter of general principle manipulate environmental, defense, or other national objectives in the ephemeral hope of producing an industrial structure more to our liking. Our economic and social policy should be based on the proposition that

American industry must adapt to serve the reasonable needs of the nation and not vice-versa.

It is true, however, that different regulatory agencies of the government may sometimes promulgate, in a short space of time, a series of regulations, no one of which which poses unwarranted adjustment costs for an industry but all of which taken together may do so. Periodic reviews, cutting across all relevant agencies, of the major policy actions facing specific industries may be a useful device to ensure that the accident of timing does not impose excessive adjustment costs in particular industries.

Such interagency reviews, including one for the automobile industry, were begun in the last year of the Carter Administration. These reviews, however, should not be the occasion to try to use environmental or other regulatory policies as a backdoor device to change the industrial structure of the country. By their very nature, the policies I am referring to have been established to promote national objectives which are important for their own sake. Such policies are necessarily carried out by different agencies of the government. There is no way they can, or should, be centralized in some Department of Industry and Trade, and used as instruments to promote a governmentally designed industrial policy.

There is a second category of federal policies affecting the structure of industry. In response to political pressures, and sometimes out of sheer ignorance, we often adopt policies which protect and reward or, in some cases, penalize particular industries and distort the structure of the American economy.

Examples abound. The recent liberalization of depreciation allowances was a good idea, but the way it was carried out in the 1981 and 1982 ammendments to the tax code inadvertently provided substantial subsidies to investment in some industries while continuing heavy tax burdens on investment income in other industries. (Investment in new factory building were particularly penalized.) We provide substantial trade protection to some industries at heavy cost to consumers. And we give out large and unwarranted subsidies to other industries, the U.S. merchant marine being a key example.

These policies are almost always harmful. By diverting investment and output to less productive and less efficient uses, they lower productivity and impede economic growth. They may sometimes provide jobs in favored industries, but they do not increase employment for the economy as a whole; Employment gains in the favored industry are matched by losses in others. What is needed here is <u>not</u> better coordination of such policies, but their elimination. Indeed, an effort to coordinate such policies could be dangerous. One does not have to be a cynic to forecast that the surest way to multiply unwarranted subsidies and protectionist measures is to legitimize their existence under the rubric of industrial policy. The likely outcome of an industrial policy that encompassed some elements of both "protecting the losers" and "picking the winners" is that the losers would back subsidies for the winners in return for the latter's support on issues of trade protection.[14]

And so, the "coordination" argument for an industrial policy turns out, on examination, to have little content. Indeed, it is a curious logic which cites examples of how political pressures have produced inconsistent policies that are harmful to the nation's industrial structure, in support of an argument for entrusting even more economic decisions to the same political system.

Along similar lines, the argument is also made that we do provide assistance to individual firms, on occasion and in a very ad hoc way; the Chrysler and Lockheed bailouts are usually cited as examples. Should we not, therefore, regularize and rationalize this procedure, rather than making these assistance decisions on a case-by-case basis? In fact, the ad hoc approach is precisely the right approach. To every rule there are exceptions. It may very occasionally be in the public interest to supersede the market's judgment and to prevent the bankruptcy of some major firm. But it is a virtue that a special law is now needed for each case. It is a virtue that each case is, in fact, treated as an exception. Only very exceptional cases are likely to muster the support needed to enact a special law, and the government's bargaining power, to impose needed and painful reforms on management and labor, is consequently enhanced. Should this process of decision by exception be supplanted by an ongoing authority to initiate bailouts, the result would almost surely be a politically vulnerable fund, available to help avoid or delay politically sensitive plant closings.

Some Real Problems

To say that industrial policy is a dangerous solution for an imaginary problem is not to say that the United States has no serious economic difficulties. It has a number of them.

Our most immediate set of problems is macroeconomic in nature. Recovery from the deepest recession of the postwar period has just begun. Having paid a very high price for partially wringing out a stubborn inflation fifteen years in the making, we — along with every other industrial country — will have to walk a very fine line to sustain an economic recovery vigorous enough to make substantial inroads on unemployment, but not so buoyant as to risk a resurgence of inflationary pressures or inflationary expectations.

In addition we in the United States face the special problem of a political impasse that threatens to perpetuate very sizeable federal budget deficits even as the economy recovers towards full utilization of its resources. Since the Federal Reserve is most unlikely to accommodate these high employment deficits with large and inflationary increases in the money supply, failure to break the impasse with tax increases and spending cuts would extend today's high real interest rates — or, more likely, even higher ones — into the indefinite future. This outcome would have particularly serious consequences for the health of America's industrial structure. High interest rates would tend to perpetuate overvaluation of the U.S. dollar, and would continue to penalize American exports and encourage imports. At home, the high interest rates would especially depress purchases of durable manufactured goods. Finally, the ability of new and young enterprises, at the frontiers of technological advance, to raise new capital could be seriously impaired to the extent that the actuality and the expectation of continued high interest rates depressed stock market values.

Getting America's monetary and fiscal policies in order is far more important for the health of the nation's industrial structure than any conceivable set of new industrial policies. What now seem to be serious problems of industrial structure would quickly shrink and become far more manageable with a few years of balanced economic recovery at lower real interest rates.

After the achievement of a sustained and balanced recovery, the prospects for which depend heavily on how the government uses its macroeconomic tools, the next most important factors influencing industrial performance are mainly beyond the government's control — such things as the pace of technological progress, the course of labor-management relationships, and the stability of world markets. There is, however, a variety of governmental microeconomic policies that can affect, favorably or unfavorably, the vigor and adaptability of American industry. Choices among alternatives in this area sometimes pose very difficult tradeoffs between economic efficiency and other social goals. For example, environmental considerations compete with the objective of keeping industrial costs low. The provision of generous tax incentives for risk bearing has to be balanced with the objective of a more equal distribution of income. Additional federal support for scientific and technical education would conflict with the goal of budget expenditure control. In other cases, what is at issue is not a tradeoff among competing national objectives, but the reform or elimination of provisions in tax or regulatory codes that distort the pattern of investment among different industries. The 1981 liberalization of depreciation allowances, for example, was desirable in the aggregate but very arbitrary as among investments of different types. It sharply skewed rates of return and distorted investment incentives among industries. Determining the federal government's stance on these and other thorny issues will continue to provide grist for the legislative and political mills in the years ahead. How they are settled will have an important, even if not overwhelming, influence on the behavior of American industries.

The most critical and vexing structural problems that American society will have to face in the coming decade have little to do with the issues raised by industrial policy. Even with a return to prosperity, unemployment among America's black youth will remain scandalously high. Large parts of American central cities will continue to be afflicted by serious financial constraints, social problems, and physical decay. And, if recent studies are to be believed, the quality of American education has been deteriorating for a number of years. Unfortunately, no one yet seems to have a very clear idea of exactly how the federal government can best play a constructive role in fundamentally reversing these very troubling structural trends. But we must keep searching for solutions — and where federal outlays are required to experiment with promising approaches, these are the areas, unlike most others, where the benefit of the doubt ought to be given a little more rather than a little less funding.

In sum, there are changes in in federal fiscal and money policies that could help the economy generally, and industry in particular, attain a more satisfactory level of economic prosperity. There are microeconomic policies that we know could contribute to an environment that is favorable to the creation of new and rapidly expanding lines of business and to the adaptability of American industry. In many cases, formulating these policies requires making some very difficult choices among competing national objectives.

In addition, there are a few very important structural problems for which, at the moment, no convincing solutions are in sight. Yet it is absolutely essential that we keep searching and experimenting to try to solve them.

One structural problem, however, that does not exist is the de-industrialization of American industry. And one set of government measures that we do not need is an industrial policy under which the federal government tries to play an important role in determining the allocation of resources to individual firms and industries.

We have enough real problems without creating new ones.

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1. Ira Magaziner and Robert Reich, Minding America's Business, Harcourt Brace Jovanovich, New York, 1982, p. 4.

2. In a forthcoming Brookings book, Robert Z. Lawrence documents in substantial detail the absence of any trend toward de-industrialization in the United States during the 1970s and, in particular, the fallacy of the proposition that international trade has contributed to depressing output and employment in American manufacturing. This section of the paper owes much to his work.

3. To reduce distortions caused by cyclical influences (U.S. recessions in 1970 and 1980), average outputs in 1969-70 and 1979-80 were used to make the decade output comparisons. The European average was held down by the very poor performance of the United Kingdom, but even if the United Kingdom is excluded from these calculations, the growth of manufacturing output in the United States still exceeded that of the rest of Europe as reported by the OECD data. The U.S. Bureau of Labor Statistics produces an alternative set of manufacturing output measures for selected countries; according to these data, the United States outperformed Germany and the average of eight European countries, but grew slightly less than the European average (33.5 vs. 36 percent) if the United Kingdom is excluded.

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4. During the cyclical peak of the Vietnam war boom, 1965-69, the constant-dollar manufacturing share averaged slightly higher (30 percent) than it did in both the early years of that decade (28.2 percent) and the last years of the 1970s (28.6 percent), but by no more than can be explained by the strength of the boom.

5. Marc Bendick, Jr., and Judith Radlinski, "Workers Dislocated by Economic Change: Do They Need Federal Employment and Training Assistance?," National Commission for Employment Policy, Seventh Annual Report, Appendix B.

6. Long-term unemployment rates (percent of the labor force) in 1979 were: United States (1.14), United Kingdom (1.92), France (4.41), Germany (3.35). The long-term unemployment definition — 15 weeks or longer for the U.S., 14 weeks for the U.K., and 3 months for France and Germany — does bias the U.S. rate down relative to the others, but not by enough to account for those differences. Economic Report of the President, January 1981, p. 127. These findings were confirmed by a later OECD analysis reported in Economic Outlook, July, 1983, p. 46 (Table 15).

7. Martin Neil Baily estimated, more generally, that none of the slowdown in American productivity growth since 1973 can be explained by a shifting composition of output among major American industries. Baily, "The Productivity Growth Slowdown by Industry," Brookings Papers on Economic Activity, 2:1982, pp. 445-51.

8. Based on OECD estimates of gross fixed capital formation as a percent of gross domestic product (GDP). Economic Outlook 1960–1980, Table R-3. The difference between GDP and GNP is small and does not affect the basic comparison between the United States and Japan.

9. Interview in Manhattan Report on Economic Policy, Manhattan Institute for Policy Research, Vol. II, No. 7, October, 1982.

10. Paul Krugman, "Targeted Industrial Policies: Theory and Evidence," a paper prepared for the Conference on Industrial Change and Public Policy, sponsored by the Federal Reserve Bank of Kansas City, August 25-26, 1983.

11. 1983 growth as forecast by the OECD, Economic Outlook, July, 1983.

12. Assar Lindbeck, "Industrial Policy as an Issue in the Economic Environment," The World Economy, December, 1981.

13. Krugman, op. cit., pp. 6-8.

14. The chief executive of a firm producing semi-conductors has recently argued that his industry does not need special government help — only a "Buy America" provision for its products.

Representative LUNGREN. I want to particularly thank you for the quality and the preparation of your presentation. It is very helpful for us in creating a record on this issue.

Mr. Weil.

Mr. WEIL. Thank you.

Representative LUNGREN. Your statement will be included in the record. You may proceed as you wish.

STATEMENT OF FRANK A. WEIL, FORMER ASSISTANT SECRETARY OF COMMERCE FOR INDUSTRY AND TRADE

Mr. WEIL. Thank you, Congressman Lungren. I will not read my prepared statement, as Mr. Schultze did not. Nor will I be as eloquent as he was.

Mr. SCHULTZE. Or as long, I hope. [Laughter.]

Mr. WEIL. I am undoubtedly a certified case for insanity for being willing to sit between these two very distinguished, much more knowledgeable gentlemen.

I am reminded—and the fact that there are three of us tends to bear this out—that this hearing may be another case of three blind men and an elephant. Depending on how one comes at this issue—since the essential base of facts is the same—if a person grasps one part of the fact base as opposed to another, he may come to a quick different conclusion.

Charlie Schultze, whom I admire enormously, makes a very powerful case for essentially two things. One, that macropolicy is, by a wide margin, the most important part of our economic process. I do not disagree with that statement as far as it goes. But, it leaves out a large part of the problem.

I agree that without competent monetary and fiscal policy in this country, there is no industrial policy of any sort that is going to make a significant difference to our overall economy. But we do not have competent macropolicy and it is going to be a long time before we do. Even if we did, in my judgment, we are still left behind with a series of problems that need to be addressed.

The second point Charlie makes which I do not agree with, is that our system cannot perform or tolerate an industrial policy process. There is not time to touch on all of his points, but I will try to address some of them.

The reason why I differ with him is that he has overlooked two important things. Despite his characterization of what happens in Japan, the truth of the matter is that common to all of our major industrial competitors in the world and many others as well, particularly in nonmarket economies, there is some national effort being made to coordinate policies for economic development.

I have been chairing a group of the Council on Foreign Relations in New York for the past year which has been looking at what is described as business-government relations in a number of different countries. Without going into a lot of detail, all countries have some identical policy; often different and many not very effective.

But there is one clear and common theme—those nations have perceived a need across their political spectrum to see if they can figure out what is going to be in their collective national interest.

A little bit of history here is helpful. Through the midsixties, the United States dominated the world's economy. We essentially dictated the terms of doing business around the world. We often forget that it was not until 1964 that Japan became a member of the OECD and joined the GATT. Japan was a developing nation until 19 years ago, and Europe was busy rebuilding its cities and factories.

We were one-third of the free world's GNP in 1950; we are less than 20 percent today.

We were an endlessly rich country which was driven by two essential policy objectives. One was to rebuild the rest of the world because that was going to be in our interest. The other was to open our borders because that was going to be in our collective interest. We had a terrible fear of a repeat of what happened in the thirties. The policies of this country, some of which I saw and participated in, along with Charlie Schultze, during the Carter years, continued to be based upon the assumption that this country was as rich relatively as it had been through the sixties and seventies.

Then came the Vietnam war, where we tried to mix guns and butter—I don't need to repeat that history. We could not afford that war and we laid down the foundation for many of the inflation problems that we have had since.

Next came Watergate and all the problems related to that which distracted this country for a period of 3 to 4 years from seriously addressing important public policy problems. During this time our competitors abroad were continuously working on their problems. Hard on the heels of Watergate came OPEC, which quintupled the price of oil and speeded up the process of equalizing our economy with the world. We were half a consuming, half a producing Nation, and we spent years fighting among ourselves over how we were going to share those costs and benefits. The other major industrial nations had no choice but to pass through their new energy costs since they are entirely energy-consuming nations. As a result, they adjusted much more quickly than did we.

Those were the conditions we faced while we were continuously, from the Kennedy round in 1962 to the Tokyo round in 1979, reducing barriers at the borders of the world to the movement of money, technology, goods, and services.

All a very sound scenario in theory.

During this same period of time, we were doing something else very important. The political process that Charlie Schultze speaks of came before this Congress saying—we want better health, a better environment, better pensions, and better occupational safety etc. Let me make clear that I agree with all of the social objectives of these new laws. Yet all of those undertakings were taken essentially without regard to their total economic consequences and ultimate costs. The assumption—the national assumption, not just here in the Congress—was that we could afford anything we wanted.

What we did, for reasons that I understand (and all I want to try to do now is to put a little perspective on what happened so we can see where we stand today) was accumulated along with problems related to our macropolicies—both monetary and fiscal, a whole host of new micropolicies, taken in discrete series. Those micropolicies add up today to another macrosized problem.

Now, I agree with Charlie Schultze and others that industrial policy is not one or even more of a series of particular policies which are going to fix that problem. My formulation of industrial policy is that it is a process. It is the very process of a nation trying to make coherent, affirmative and anticipatory multiple decisions about the longer term economic consequences of its collection of micropolicies.

It is the process of trying to insure that the environment in which private business decisionmakers reach their decisions, not only are the tax and the money issues understandable, but the whole collection of other micro-public-policy issues that impact upon private decisionmakers are understandable and predictable.

I agree that it is very difficult in our political system to make choices. Yet we do all the time. Charlie is quite right—with the EDA, the Eximbank and our tax laws for example, we are constantly making choices. We do not like doing it. We deny that we do it, and say that we do not do it well. But, in fact, we are making choices all the time. And, we are doing it because we do have an invisible unconscious industrial policy in this country. It is a random collection of decisions and choices, money made in the Defense Department, which are impacting upon the industrial objectives and goals of this country.

The fact that it is difficult to make sensible choices, the fact that it is not necessarily consistent with many aspects of our political history, does not mean that we ought not to try at least to think about how we might go about doing it better.

Even Charlie, who stated that we have not deindustrialized, agrees that we have more unemployment and structural problems then we used to or can afford. We have problems in steel, autos, and agricultural equipment and many other sectors and regions.

There is no question that even if we fixed all the macropolicies that he speaks of, we will be left behind with a substantial series of structural problems. They, too, are not going to be entirely fixed by an industrial policy process. But, if one is willing to accept the fact that there is a problem in this country that goes beyond fixing our tax and our monetary system, then a coordinated industrial policy is not just a solution in search of a problem. True, the problem is not simple and it is not singular and it does not lend itself to a simple, singular solution. This is why Charlie is wrong and that is why we need a new process to address that problem.

Now if there is a problem in this accumulation of micropolicies, how does one solve it? And I am not suggesting for a moment that we should try to undo the last 30 years and take away all the new rules and regulations. I would not want to do that because I believe in the goals of those policies. Moreover, I do not think that it is politically practical to roll back because I do not think the people of this country want to ignore those social goals.

But we can do a better job of applying those policies. If you believe that there is no problem, then what I am about to say will not make sense. But if you accept the fact that there is a problem that will not be addressed only by better macropolicy, then the question is how do we go at it?

First, in my opinion, you do not go at it with a bank. I think money is part of the solution, but it is a relatively small part of it. The proponents of the bank concept have come from an experience where money was the leverage or, as some said, the brick wall, that brought about the trade-offs that solved those problems.

At this level of the Federal Government in the international scene, money alone is not going to be sufficient leverage, or even the right mechanism to bring about all the complex trade-offs necessary to make us competitive.

In my opinion, what we have been missing in this country and what we see in other countries in different ways—consistent with their different political economic cultures—are the following ingredients of an industrial policy process.

We see some long-term orientation and we see some semiautonomous political points of view.

Over a year ago, I started saying that I thought that one of the analogies we might look at would be our Federal Reserve System, procedurally. People laughed at that point and they said, how could anybody hold up the Fed as an example of anything good.

Mr. MELTZER. Right.

Mr. WEIL. Yes some people still say that. But, a lot fewer say that today because the truth is that the Fed, over a 70-year period of time, has evolved a substantial amount of credibility in our system. It has the ability—to some extent—to lean into the political winds of the moment, and do things which may be unpopular at that time. The fact that some people do not like all that the Fed does—including me at certain points last year—is why they need some independence. Their ability to run a bit contra to current political trends—which tend to shift very quickly in this country with the advent of mass media and opinion polls—is something that we need. We also need that independent view at times when we are impacting the micro-public-policy environment in which private business independent decisions are made.

There are important reasons why the private business decisionmaking process with respect to investment and disinvestment have been affected as they have.

So we need to have a process which has a little bit of detachment in political terms and a little longer point of view to improve the decisionmaking with respect to many business investments in this country which have a time horizon as long as 8 or 10 years. If a business decisionmaker does not have the faintest idea what the public policy current environment is going to be 8 or 10 years in the future much less 2 years, he will be much less likely to make the investments necessary to make us grow and be competitive.

In many of our competitor nations, despite the fact that they may have better macropolicies—and many of them do not—they have a better sense of where they are going to be in the future in micropolicy terms. Their policies that will affect their environment, that will affect their savings rates and many other policies are better understood and made predictable. The result is that their investment rate is now much brighter than ours.

Japan has had one political party in power for the last 32 years. That has helped with their consistency and predictability. I am not suggesting that we could attempt that kind of consistency. We simply would fail. But we can try to work around that reality.

If one wants to have a process that has a semiautonomous point of view and a long-term point of view, in my opinion; it is necessary to combine, to some extent, three additional factors: Knowledge; money; and power.

Knowledge, in my mind, is to be distinguished from information. It is basically what one makes of information. There is a big difference between knowledge, forethought, the ability to look around corners, to anticipate things, and planning. I do not propose that we have a central planning agency. That will not work in our system. But, if we could be sophisticated enough as a nation to draw a distinction between knowledge and planning, I believe we would unblock ourselves from an important goal.

The U.S. Government has a great deal of information, but very little knowledge. I learned that when I was in the Commerce Department. We had bits and pieces of information all over the place, but we rarely, if ever, assembled it in one place in a useful way that one might call knowledge.

A small agency that would have the ability to think ahead would benefit us all by drawing our attention to the broad consequences of the future.

A little money would help, too, because it would draw the attention of the private sector. Charlie Schultze would say that it brings people to the trough. I say that it brings the private sector to the table and gives a government body the ability to put something on that table to offer in exchange for the tradeoffs that are essential to make the United States competitive.

My comments here are very brief. More detail is contained in my prepared statement and in the paper I have given you as well.

Power is the most complicated dimension because one of the things that nobody in government wants to do is give up power. But, there is a modest form of power that could be very helpful. That is the official power to intervene in the governmental process; intervene in the rulemaking process; intervene in the regulatory process; intervene in the legislative process bringing another, broader point of view to those deliberations.

In the last 20 years two men, one with a pipe and the other with a cigar, have come up here to tell you what they think. You do not often agree with them, but the very fact that they come up here in a dispassionate way and give their point of view has been a salutory part of our governmental process.

I have heard a number of Members of this body, both in the House and the Senate say, if only we had known certain consequences before we did something, we might have done it differently. In one particular case, one well-known Senator said just that regarding the ERISA legislation. I said to him, ". . . but you did know that. You had witness after witness who came before you and said, consider the possibilities of the impact upon those changes on the investment patterns of the United States." He said, "well, we did not believe those guys. They were all self-interested." If a dispassionate trusted government figure had been able to say those things, they may have legislated differently.

Other than an occasional professor, and many self-interested witnesses, you do not have many people coming up here who take a whole broad point of view on the long-term economic consequences of the many micropolicies you have to deal with.

You had one whack at this notion of intervention just a few years ago in 1977, when there was a proposed consumer protection agency. It was beaten back because the business community at that point questioned why the U.S. Government should subsidize one particular point of view, even as broad as a consumer. The consumer allegedly was able to intervene in most proceedings without having an agency to do it for them.

This Government could use an agency that is able to look at the broad, whole point of view and come up here before you legislate on different things and go before other parts of the Government before they make rules and regulate on certain things and say, "at least consider the following."

For example, there is a matter before the Federal Trade Commission today that involves a very important, fundamental issue. The particular decision will signal other things beyond its own specific merits. Do we want foreigners to come and invest in this country? The House is favoring so-called local content legislation, which means come over here and invest and help build cars; yet, the Federal Trade Commission now has to make a decision on whether Toyota and GM can cooperate to do that. A broad view beyond antitrust consideration might help. I surely do not have the answer.

In sum, the conditions of the world have changed. The aggregate of micropolicies is a macroproblem.

I believe that problem needs to be addressed in some way. It does not necessarily need to be addressed with one particular set of policy formulations. But we need to apply a new process, something that does not exist in our present legislative system. Thank you.

[The prepared statement of Mr. Weil, together with the paper referred to, follows:]

Prepared Statement of Frank A. Weil [1]

"U.S. INDUSTRIAL POLICY IS A
PROCESS IN NEED OF A
FEDERAL INDUSTRIAL COORDINATION BOARD"

Mr. Chairman and members of the Joint Committee, I am honored to have this opportunity to testify before you about industrial policy. Your recognition of the importance of this subject and of the possible need to consider new policy approaches is itself a real step in the right direction.

I became seized with the fascination of this subject in 1978 while I was serving as Assistant Secretary of Commerce for Industry and Trade, and when, in that capacity, I became Chairman of the Industry Committee of the OECD. In the past two years, I have participated in the Harvard Seminar on Industrial Policy, and the Industrial Policy Task Force of the Center for National Policy. Those experiences taught me about the subject generally and in particular what other countries are doing.

You know the economic history of the past 20 years. However, a brief review of certain highlights will help put in context the changes that make a new approach to industrial policy a necessity.

1/ Partner: Wald, Harkrader & Ross. Mr. Weil is testifying as an individual. His views are personal and do not necessarily reflect those of his partners. He has a variety of domestic and foreign clients who have a general interest in this subject, but the preparation of this testimony is not in any way on their behalf and is not being billed to any client.

From World War II to the mid-1960s, the U.S. essentially dominated the world economically and, for most practical purposes, we dictated the terms on which the free industrial world did busienss. Europe and Japan were preoccupied rebuilding their cities and infrastructures destroyed in World War II. We were forging ahead in the development and marketing of new technologies. But they were hardening their muscle tone by having to try harder. We sometimes forget that Japan did not join the OECD or the GATT until 1964.

Though we still are the biggest and strongest, since the mid-1960s we have slipped in our relative dominance: e.g., our share of world GNP has declined from one-third in 1950 to one-fifth today.

The Vietnam war hurt us badly; the combined overspending on guns and social programs created the virus for inflationary diseases. Those problems led to the inevitable destabilization of the dollar and in 1971 to the abandonment of fixed exchange rates which, instead of curing our problems, created new ones.

Watergate distracted us from seriously addressing almost all problems including our structural economic problems. In addition, because our citizens lost confidence in the authority of our government--despite the fact that the Congress ultimately did its constitutional duty very well--we lost valuable time that was well spent by our competitors.

Then OPEC and the rapid and large rise of almost all energy prices accelerated the process of equalizing or reducing our advantages over our competitors. Europe and

Japan adapted faster to the consequences of OPEC's actions because in order to survive they had no choice--they are almost entirely dependent on foreign energy sources. To pass through the rise in energy costs, they improved their internal cooperation in their national industrial policies and became more efficient. We, on the other hand, were much slower to adapt because we produce more than half the energy we consume and are unaccustomed to concentrating on the sale of exports to finance the import of fuel. So our producers and consumers spent years arguing how to allocate between themselves the costs and benefits of the OPEC-induced value changes in our energy structures. We ignored the facts that not only were we losing any competitive edge we may have had in world markets, but we were being beaten in price and quality by foreign products in our home market. On balance, we were slipping a bit and stagnating due to our internal conflicts. Europe and Japan were catching up and pulling themselves together on the same issues.

In the meantime, around the world we were reducing barriers to the flow of goods, services, technology, and money. And, trade grew faster than most national economies. An unforeseen by-product of those reductions of border barriers was the increase in the effectiveness of the various national industrial policies in other economies. Specifically, the previously highly independent U.S. economy became more interdependent (read dependent) on what was happening in foreign economies. Inevitably, that had to lead to structural distortions in our economy, which has contributed to a lot of our unemployment problems today.

The U.S. continued its traditional reliance on macro-policies, such as monetary and fiscal devices, to try to adapt to the new economic problems brought on by the catch-up efforts of Europe and Japan and by the special effects of Vietnam, Watergate, and OPEC. Those macro-policies are critical. Without sound macro-policies, no industrial policy can offer significant help. But even with sound monetary and fiscal policies (which seem almost unattainable today), we have an accumulation of micro-policy problems that add up to the equivalent of a third major macro-problem.

I agree completely with Charlie Schultze that, to cure our economic ills, it will be absolutely essential to have decent monetary and fiscal policies. However, he seems to fail to recognize the confusing effect which the aggregation of the strands of inconsistent micro-policies has on private business decisions in this country. It is true that the specific micro-policies that add up to industrial policy when taken separately are not at the same level of importance as monetary and fiscal policy. But, together, they amount to a third major element of our economic environment. The strands of our micro-policies that are known by various rubrics such as government-sponsored research and development; tax and antitrust laws; government procurement, loans, and guarantees; and environmental, health, and safety regulations constitute a vast array of stimuli which on the whole are contradictory, *ad hoc*, and reactive. Those stimuli confuse and even paralyze private decision makers. The broad result has been a major, across-the-board, effect on private decision-making that has lead to a short-term perspective and a negative effect in our savings and investment habits, at least as compared to our foreign industrial competitors. When a private decision-maker cannot assess and predict the public micro-policy environment in which he has to deal, he inevitably grows too cautious. The phenomenon of contradictory micro-policies create a macro-economic problem that needs a solution.

The major problems we face in being globally competitive in steel, autos, chemicals, textiles, farm equipment and even in some advanced industries, such as microprocessing and computer technology, are real. Some macro-data may appear to contradict that fact. But, talk to the players (business and labor) in those games and you will know those problems are real. Improved macro-policies will help but won't solve their problems. We are suffering from the confluence of all the facts I have just enumerated:

- foreign competitors who are determined to pull their domestic acts together to become globally competitive
- an agglomeration of U.S.-based mistakes on macro-policies
- an accumulation of important, socially useful U.S. micro-policies that failed to consider overall economic consequences
- substantial reduction of border barriers that allows other countries' industrial policies to flow more easily into our economy

There can be only two ways to deal with that overall situation.

One is to change the border situation and the rules of global trade. Ironically, some of industrial policy's biggest critics suggest that is what industrial policy itself will do. But, the reverse may be about to happen. Both the House Committee on Energy and Commerce and the Trade Subcommittee of the Committee on Ways and Means are about to go forward with the most comprehensive and potentially dangerous new set of protectionist steps since Smoot-Hawley in 1930.

The other way is to seek to get our own act together affirmatively--by far the better option, because it could lead to more trade, not less.

The proposed solution is now being debated under the general heading--industrial policy. An industrial policy for the U.S. is not something as specific as one or more particular new policies. Industrial policy is the very process of helping to weave a coherent, affirmative, and anticipatory set of micro-policies that will affect our economy. A more predictable micro-policy environment can lead to better private business decisions just as much as better monetary and fiscal policies. They are all part of the same environment.

Let me explain what I mean by process. Today the strands of the micro-policies we create are taken in discrete, ad hoc steps through the unfolding of our competing political system. Over the past 25 plus years, we have dealt in series with a wide variety of subjects to improve the quality of our society: better pensions, environmental concern, occupational safety, etc.

I have no quarrel with those needs or the fundamental approaches we took; quite the contrary, I favor virtually all those public policy steps. I would try harder, however, to integrate these efforts into a coherent economic program. Most of our industrial competitors have developed much of the same social legislation. But, they did it differently and coherently enough to avoid some of our mistakes. In Europe and Japan, business, labor, and government worked together to formulate a process that combined a competitive posture and quality-of-life goals. Neither our legislative nor executive branches has been able in the main to take a holistic view of our economy as we went about solving our social problems--so we overdid some things just enough to distort business decisions. As we formulate micro-policy, we need to relate each piece better to our overarching economic goals. This is the fundamental purpose of creating a new industrial policy process--to build into our political system a method appropriate to our culture and history to seek to create consensus. It could help to coordinate the application of our numerous micro-policies so that private decisions could become longer-range and more dependable.

At this point, I offer for your information and the record my comprehensive views on this subject published recently in Law and Policy in International Business (Vol. 14, No. 4, 1983), and also a suggested outline for a piece of legislation which could create an industrial policy process. Then let me summarize what the process would consist of.

Semi-Autonomy and a Long-Term Perspective

I propose that we create a new institution, which could be called a Federal Industrial Coordination Board (FICB). An FICB could combine semi-autonomy and a long-term perspective--the two main elements we need to accomplish the changes necessary to improve our micro-policy environment. Semi-autonomy is necessary to gain a bit of distance from the immediacy of partisan politics that often conflicts with economic necessities. An example of a good mix of semi-autonomy and democratic responsiveness is the Federal Reserve Board. Until recently you might have laughed at that statement. But, over the past 70 years, the Fed's semi-independence has on balance served this nation well. And, many serious politicians privately admit it serves their political purposes to publicly complain about the Fed--as long as it can keep leaning into the wind. And remember, too, the Fed has never gone upstream against contrary political currents for too long. They hear your criticisms loud and clear--as we saw in the fall of 1982. The long-term perspective is necessary to have a continuity of policy and encourage investment. Japan's 30-year old Liberal Democratic Party majority, and Europe's business-government relationships, which have continued despite changes in political parties, have given both an edge over our pluralistic and adversarial way of reaching decisions. The research and development of new technologies; competitive marketing technologies;

and the management of energy, environmental, and training problems require a sustained effort longer than the tenure of a particular Congress or President.

To have semi-autonomy and a long-term perspective, an FICB must have three ingredients: knowledge, money, and power. All three ingredients must be combined in some degree to command and keep the attention and respect of the many constituencies that must be part of the overall process.

Knowledge

Knowledge builds on information; it is more than information. Knowledge integrates facts and thus helps make information-based decisions. We need a centralized method of gathering industrial information. While the U.S. government gathers a tremendous amount of information, it is spread among a plethora of agencies and rarely comes together as knowledge. We need to analyze industrial data and be in a position to anticipate and identify national priorities. We simply don't do that today. We should try to set broad goals for our industrial development. An FICB could recommend to the President and Congress national, regional, and sectoral industrial goals. We need a body that can be authoritative but not so powerful as to be directive.

The Japanese do this very well. Their Ministry of International Trade and Industry (MITI) orchestrates white papers that produce visions that define broad goals for the coming decade. The process they employ to do this is itself very instructive. As many as 2,500 people in business, labor, government, and academia, working through a layered-committee structure, spend a year and a half in arriving at about a thirty-page document on which all parties agree in principle.

Once those national priorities are agreed upon, MITI helps to harmonize and integrate specific industrial policy through small signals. MITI doesn't any longer actually direct policy, but it sure does still influence policy. We need a body with a similar holistic approach to try to do the same thing. Moreover, we need to meet with our European and Japanese counterparts to coordinate with them the formulation of each country's national industrial policies. Knowledge is at the root of the process; we don't have it today. And, knowledge doesn't mean centralized, indicative, or coercive planning.

Money

We need a forum to work the trade-offs between business, labor, and government. While everybody says we need better cooperation between business, labor, and government few say how. It is not likely to happen on its own. In crises such as the Lockheed, New York City, and Chrysler impending-bankruptcy situations, money may be sufficient leverage to force the players to cooperate. Money will help to bring people to the the bargaining table. But, money alone is insufficient and the Bank (RFC) concept alone, in my opinion, is not the way to develop an industrial policy process.

We need to manage some incentives and disincentives to encourage enterprises to achieve national goals. We need to be able to attach conditions to government help. Today, our government's ability to do that is limited. We should be able to certify the use of certain investment tax credits if conditions are met; that would at least have avoided safe-harbor leases. We perhaps could provide some matching funds for research and development. Some limited loan and loan guarantee ability for modernization and expansion that would encourage other investment would make an FICB credible without being too powerful.

Power

We need an FICB with sufficient clout to insure that the existing governmental system will do business with it, but not so much clout that it can usurp the powers of the existing power centers of our governmental system. It may not need any affirmative powers to command any action or inaction. I would consider giving an FICB our import and export control functions to seek to depoliticize both of them --something I believe we need to try to do. But, I doubt whether that is politically possible.

However, the power to intervene in the regulatory and rule-making process, as well as the power to appeal from that process, could be sufficient to give an FICB a real role in our system. For example, an FICB could intervene in a particular proceeding of the Federal Trade Commission or the Interstate Commerce Commission and present the argument for a decision or rule in conformity with broad national needs. This intervention power could significantly contribute to the coordination of diverse micro-policies which that forum or the parties may not have weighed. Yet, the traditional governmental decision body would still be the final arbitrator.

The question is legal standing--to become involved legally as well as practically. Few private groups, even if they can justify a legal standing, have either the financial resources or the credibility across-the-board on all national issues to appear and apply serious weight to the regulatory process. If an FICB had a broad mandate to intervene in the regulatory process, it inevitably would become a factor to reckon with. Even the threat or suggestion of a prestigious intervention could be influential.

In 1977, Congress debated the possibility of such a power to intervene for a proposed Consumer Agency. That debate is instructive today. Critics asserted that the proposed Consumer Agency would thus subsidize only another special interest. An FICB that would take a holistic view of our micro-economic problems seems to me clearly something worth subsidizing--the interest would be the whole national interest.

Structure

An FICB could operate procedurally like the Federal Reserve System. The Board could consist of nine members, for staggered, ten-year terms, nominated by the President (and possibly, in part, the Congress), confirmed by the Senate, and located in Washington, D.C. A nine-member Board is large enough to be representative of diverse interests, but not so large as to be unwieldly. The Board should be full-time because part-time boards are really staff-managed. Diversity of regions, industrial sectors, labor, consumers and political parties should be sought.

There could be some regional subdivisions to get a broader involvement of the various industrial centers of the nation. The regional elements would help implement FICB policy and communicate to Washington their more intimate feel for the realities and needs of their regions and sectors.

There are many permutations and combinations possible. The structure of an FICB is very important and may be the issue we should give detailed attention to very soon. With some better coordination of knowledge, money, and power, an FICB could over time earn the nation's confidence and contribute to a significant improvement in the U.S. economy.

In a nutshell, Mr. Chairman:

- Contrary to Mr. Schultze's view, there is a problem that transcends the capability of improved macro-policy.

- That problem is the confluence of a changing world economy and our marvelous penchant for pluralistic divisiveness.

- Our problems will not go away magically, so we must try to find a solution that balances our cherished political system with a need for a new type and level of cooperation.

- We are more likely to find the solution in a new type of institution than in eliminating old ones or eliminating laws and regulations that represent a national consensus.

- What is needed is an FICB with i) knowledge that integrates the assorted facts, ii) just enough, but not too much, money to spark investment, and iii) power to clarify issues.

- If we don't do something like this soon, we may be engulfed by a new form of protectionism that might trigger a real world-wide depression.

I am optimistic--if we try. To say that we can't create new political institutions is to deny our history. We have been doing it for over 200 years. Let's not stop today because it is difficult.

Thank you, Chairman Lungren and members of the Joint Committee. I will be pleased to try to answer any questions you may have.

CONGRESSIONAL FINDINGS, PURPOSES, STRUCTURE, AND POWERS OF A FEDERAL INDUSTRIAL COORDINATION BOARD

A bill to create a Federal Industrial Coordination Board and to authorize such Board to develop a national industrial strategy, to coordinate federal, state and local regulatory actions to foster that strategy, and to provide financial incentives to implement that strategy.

Title

The "Federal Industrial Coordination Act of 1982."

Findings

(1) The United States is suffering its worst economic decline since the 1930s. The combination of declining investment, an eroding industrial base, foreign competition, severe inflation, and continued recessions has revealed basic structural deficiencies in the United States economy that have been intensified by *ad hoc* and conflicting short-term economic policies and governmental solutions.

(2) Unless the structural deficiencies in the United States economy are addressed, the current economic decline could lead to prolonged and severe unemployment, underutilization and closing of industrial facilities, regional dislocations and loss of dominance in world markets.

(3) The reduction of trade and financial barriers over the past three decades has exposed the United States to intense international competition resulting from the successful coordinated and affirmative industrial policies of several of our trading partners.

(4) The United States has no coordinated industrial policy to help anticipate, understand, and control the direction of our industrial development. The absence of such a coherent industrial policy is a primary cause of the deteriorating domestic and international economic position of the United States.

(5) Government solutions to industrial problems have been reactive, uncoordinated and ad hoc with no overall strategy or direction. In many instances, governmental promotional efforts have been misdirected, insubstantial or after the fact. In certain instances, federal regulatory activities and state promotional programs have been detrimental and counterproductive to industrial well-being.

(6) No agency of government is:

(a) responsible for acquiring a long-term view of the national economy and its component, regional and international interrelationships. Without such information, it is not possible to develop a coherent and coordinated industrial strategy, to identify and anticipate emerging problems, and to advise the President and Congress about timely and effective action;

(b) responsible for synthesizing the views of industry, labor, banking, consumers, state and local government and other interested groups with regard to the overall and long-term industrial goals of the United States economy and the recommended strategies for accomplishing these goals;

(c) capable of developing and implementing a long-term coordinated industrial strategy insulated from the pressures of near term electoral politics.

(7) The Federal Reserve System provides a model of a successful semi-autonomous institution that can balance the short-term needs and long-term goals of the United States economy. An analogous federal institution is a necessary and appropriate response to the failure of the existing mechanisms of government to develop coherent and balanced industrial strategies.

Purposes

The purpose of this Act is to establish a Federal Industrial Coordination Board, an agency independent of the Executive Branch and Congress, with responsibility for:

(1) collecting and evaluating economic information and data required to develop and implement national, regional or sectoral industrial strategies;

(2) facilitating discussions on national, regional or sectoral industrial policy among business, banking, labor, government and consumer interests;

(3) developing a long-term national industrial strategy for recommendation to the Congress and the President and periodically reviewing and revising such strategy;

(4) anticipating sectoral or regional industrial problems and fashioning joint business-labor-government-consumer solutions to these problems before they reach crisis proportions;

(5) formulating specific regional or sectoral industrial goals to promote expansion or revitalization of regions or industries with an imbalance of resources;

(6) implementing the national industrial strategy and specific regional or sectoral strategies through stimulation of capital or human resources into appropriate areas, intervention at federal, state or local regulatory bodies, and recommendation for changes in federal or state law.

Structure

(1) The Federal Industrial Coordination Board (FICB) shall be composed of 9 members, who shall be appointed by the President with the advice and consent of the Senate. Each member shall serve a term of 10 years. The Secretaries of the Treasury, Commerce, and Labor shall be ex officio members of the Board. The members of the Board shall be chosen from industry, labor, consumers, government and banking so as to be broadly representative of each sector. No more than 6 members may be members of the same political party. No member may be removed except for cause.

(2) A Chairman and Vice-Chairman shall be appointed by the President for a term of 4 years, with the first full term commencing on April 1, 1985. Neither the Chairman nor the Vice-Chairman may be removed except for cause.

(3) The first 7 members shall be appointed for staggered initial terms of 3, 4, 5, 6, 7, 8 and 9 years, so that no two member terms expire in the same year.

(4) Each member of the Board shall serve as a full-time salaried employee of the FICB. For purposes of fixing compensation of the members or employees of the Board, the federal civil service statutes shall not apply.

(5) The FICB shall establish six regional corporations, called Regional Industrial Development Corporations (RIDC), which would be the operating entities to implement the policies and decisions made by the Board. Each RIDC shall have as its Chief Executive Officer a President, named by the Board, and such other officers as the Board shall determine. Any officer of an RIDC may be removed by the Board. Each RIDC shall have an Advisory Board, composed of representatives of industry, labor, consumers and government in the region which shall direct the administration of the RIDC. The members of the Advisory Board shall serve part-time and with per diem compensation.

Powers

In order to accomplish its purposes, the Federal Industrial Coordination Board shall have the following powers:

(1) to collect information from any corporation which it deems necessary for the development or implementation of an industrial strategy;

(2) to convene meetings of representatives of industry, labor, consumers or government to fashion or implement industrial strategies;

(3) to review programs or policies of the federal government, and state or local governments, in order to determine

consistency with national, sectoral or regional industrial strategies and to recommend changes in law, regulations or policies including money supply, growth, the federal budget, credit needs, interest rates, taxes, and subsidies, antitrust and merger policy, regulatory policy, international trade policy or other policies of significance to industrial growth in order to remove any barriers or inconsistencies and foster policy coordination;

(4) to develop for recommendation to the President and the Congress a national industrial strategy which seeks to attain balanced economic growth, full employment, efficient utilization of public and private resources, equitable distribution of income, balanced regional development, positive balance of payments and meets essential national needs in agriculture, defense, education, energy, housing, raw materials, transportation and research and development;

(5) to formulate consistent with the national industrial strategy specific regional or sectoral long term industrial strategies which identify the capital and human resources required for achieving specified goals of production and recommend specific governmental, corporate, and labor initiatives for achieving these goals;

(6) to provide financial assistance, in the form of loans or loan guarantees, to banks or industrial enterprises for the purpose of research and development, or modernization and expansion in order to implement specific regional or sectoral industrial strategies;

(7) to provide financial incentives or disincentives, in the form of specific tax benefits or penalties, such as (i) modification of schedules for depreciation, (ii) allowance or disallowance of refundability of investment tax credits, or (iii) modification of time allowed for carry back or carry forward of investment tax credits or deductions for net operating losses in order to foster implementation of a specific regional or sectoral industrial strategy;

(8) to provide financial assistance, in the form of specific tax benefits to encourage research and development in order to implement specific regional or sectoral industrial strategies;

(9) to provide consultation and recommendation to the Export-Import Bank with regard to appropriate levels of export assistance provided pursuant to 12 U.S.C. § 635 et seq. in order to implement specific regional or sectoral industrial strategies;

(10) to intervene in the regulatory and rule-making process and to appeal from that process in order to present the argument for a decision or rule in conformity with broad national needs;

(11) to administer the antidumping and countervailing duty provisions of Title VII of the Tariff Act of 1930, 19 U.S.C. § 1671 et seq., as currently administered by the U.S. Department of Commerce;

(12) to provide financial and technical assistance for firms damaged by foreign imports under Chapter 3 of Title II of the Trade Act of 1974, 19 U.S.C. § 2341 et seq.

AUTHORIZATIONS

The Board would be provided an initial authorization for administration of $20 million. Thereafter, the Board will be authorized to impose reasonable fees on banks and industrial enterprises receiving financial assistance so that it may operate self-sufficiently and without annual appropriations by Congress.

The Board would be authorized $5 billion for provision of loan and loan guarantee assistance, and $1 billion for provision of assistance in the form of tax incentives. These funds should be available to the Board until expended.

Representative LUNGREN. Thank you very much and again I want to thank you for the prepared statement you have given us and also for your oral testimony. One of the things I did not want to do in coming up with a panel was having everybody agreeing with everybody else.

We will now hear from Allan Meltzer of the Carnegie Mellon University.

STATEMENT OF ALLAN H. MELTZER, PROFESSOR OF ECONOMICS, CARNEGIE MELLON UNIVERSITY

Mr. MELTZER. Economists often seem to be in disagreement. We depart from that tradition today. I agree with much of what Charlie Schultze has said. I suppose the major difference that I have is on the issue of coordination. His statement, I think, neglects the fact that we have a coordinating agency called the market system. The question at issue is not whether policies should be coordinated, but how they should be coordinated. Markets coordinate resources and resource allocation and that is the way coordination has traditionally been achieved in this country. People look at prices for labor and capital and decide how resources should be used.

The question, then, is whether Government, through something called industrial policy can improve upon that method.

In Chairman Jepsen's letter of invitation, industrial policy is defined as the coordination of Federal fiscal, monetary, trade, regulatory, antitrust and R&D policies. Coordination would be achieved by an organization like MITI. A related proposal calls for the creation of a Government development bank to lend money at below market rates of interest to fast growing firms and technologically advanced industries for the purpose of encouraging growth to firms in declining industries with the intention or hope of smoothing the decline.

We do not need a policy body of this kind, in my opinion. Coordination of economic activity under Government auspices is both unnecessary and undesirable. The proponents of industrial policy misinterpret the recent industrial history of the United States and other countries, misunderstand what has happened in the world economy, and misread the experience with industrial policy elsewhere.

Further, this type of industrial policy is unsuitable to a society of free men. Industrial policy shifts control of resource allocation and investment from the marketplace to Government agencies and delegates decisionmaking power to political appointees allegedly representing labor, capital, consumers, and other interest groups.

The method of allocating resources is more suited to a corporate state like Italy under Mussolini than to an economy that seeks to achieve efficiency and freedom. Countries with industrial policy typically restrict capital movements and regulate interest rates, as in Japan during the fifties and sixties, in Britain until 1980, and in France today.

My opposition to industrial policy does not mean that I believe that current arrangements are ideal—I do not. Changes are needed, so I offer some proposals for changes after commenting on industrial policy.

The typical brief in favor of industrial policy attributes our slower growth to a lack of coordinate planning. A typical claim is that the United States has been deindustrialized by growing competition from foreign countries and by their ability to increase their industrial production by diminishing ours. These claims are not correct. We have not been deindustrialized. The growth rate of industrial production slowed during the seventies. But I call your attention to table 1 of my prepared statement, the growth rates of industrial production in all major developed economies during the seventies, and comparing those rates to the preceding years, 1963 to 1972.

The decline in U.S. industrial growth is one of the smallest in relative size. The decline in Japan is larger in relative and absolute size. The growth of Japanese industrial production slowed appreciably during the seventies, far more than ours did, falling from a rate of growth of 12 percent during 1963 to 1972, to a rate of 3.6 percent from 1972 to 1981. The data end before the recent recession. I have omitted the recessions from these figures because I want to avoid the distortions caused by the differences in the timing of recessions and expansions in various countries.

The table supports two major conclusions. Mr. Weil is right when he emphasizes that the U.S. economy has a problem. He is wrong when he suggests that the problem is limited to the domestic economy.

What the table brings out is that the problems of the U.S. economy are problems which affect not only us, but every other major developed country in the world. Relative to the other developed countries of the world, the United States performance, while it has not been as good in the seventies as in the sixties, has been on a relative scale better than almost any other country in the world. Only Italy has higher growth of industrial production.

Table 2 of my prepared statement compares real income growth. If we could have very fast growth in real income with declining rates of growth in industrial production, I am not sure that we should depart from a policy that would produce that outcome. The aim of the policy, presumably, is to facilitate the growth and standards of living and consumption. So the growth we are interested in can be measured by what is happening to the growth of real income.

The United States has the smallest relative decline in real growth of any of the major industrial countries. These data in table 2, like those in table 1, support two conclusions—first, the decline in growth rates affected all the developed countries, not just the United States. Second, Japan did not avoid the world problem. Whatever MITI may have done or not done, it did not prevent a relatively large decline in Japanese industrial growth and in the growth of Japanese real income.

Comparative data for Japan and the rest of the world is broadly consistent with what one would predict from economic theory about growth and development over long periods of time. In a competitive world economy, with the freedom to transfer capital to countries where anticipated returns are highest, the less developed countries typically acquire capital from the more developed countries. The tendency is for capital to move in the direction of highest aftertax, risk-adjusted, real rates of return, for real growth to increase relatively in those countries where capital is growing most rapidly and for real wages to rise rapidly in market-oriented developing economies. This is clearly shown by the data that I have pointed to earlier.

Japan, Taiwan, Korea, Malaysia, and other developing countries have imported capital from more developed countries by providing higher anticipated aftertax rates of return. The opposite side of this capital movement is that the developing countries export more goods and services than they import. That is the way they get the capital.

The fact that countries like Japan, Korea, Taiwan, or, in its better days, Brazil, move from technologies that are more labor-intensive, for example, textiles, to technologies that require more skill and have greater productivity per hour, like the production of microprocessors, or to technologies that are laborsaving, such as the use of robots, is the expected result of development and the increase of real standards of living around the world.

Growing competition in industries with advanced technologies is the expected outcome of world economic development and is not by itself evidence of failure in the United States, or by the United States.

The fact that Japan now produces computers and that Brazil now produces airplanes, to choose two examples, is evidence of the remarkable advance in the market economies of the world during 30 years. We should be proud of that record of development and of our major contribution to it. These achievements impose costs and benefits on us and others. We are forced to change, to become more efficient, to adopt new methods, and to develop new products. As we become more efficient, our living standards rise. If we fail to become more efficient, if we adopt policies which slow our growth or hamper development, our standard of living rises more slowly or falls.

Proponents of industrial policy see the world as a mixture of sunrise industries and sunset industries. This is misleading. It sustains the absurd belief that somebody knows which are the sunrise and which are the sunset industries, or that the former should expand and that the latter close.

Production of ceramics is one of the oldest industries in the world, but it is currently a growth or a sunrise industry. Rubber tire production is an old industry, but it currently has new technology and new products that have produced remarkable change in the quality of tires, in their safety, in the number of miles traveled per tire, and in the productivity of workers in that industry.

These examples can be expanded almost endlessly. No one can predict when product or process innovations will make a sunset industry into a sunrise industry, or conversely. The great advantage of the market is that it does not concentrate decisions in the hand of experts or community groups, but gives opportunity to those who are willing to risk their time, talent, and money toward making investment decisions.

Public policy has encouraged, and despite some increase in trade barriers, continues to encourage, expansion of world trade and growth in the market economies of the world. Japan, Taiwan, Korea, and others could not have implemented successful growth strategies based upon export growth if the United States and other countries had not accepted the growth in imports required by those policies. Had we failed to accept their imports, the exporting countries would have been poorer, but we would have been poorer, also.

In the two decades following the end of World War II, real per capita income probably increased at a higher rate in more countries and for more people in the world than at any time in recorded history. This progress continued in the seventies, but at a slower rate. We should not abandon the strategy that produced those gains; on the contrary, we should make concerted efforts to adopt policies that encourage efficiency, enterprise, initiative, and policies that remove barriers to world trade and capital movements. We should encourage the rest of the world to do the same.

Experience in Japan, by itself, tells us nothing about industrial policy. No one should be surprised that some government decisions prove to be insightful, perceptive, and correct. It would be surprising if all government decisions were wrong or foolish and all private decisions were correct. If this were true, serious people would not consider industrial policy or government planning and direction. We would not be discussing the issue here.

The comparison of a free-market strategy and government planning and directing must be based on the total record, not on specific instances of success or failure. The record of industrial consolidation, state direction of investment in Britain is miserable, and the recent experience of France is not encouraging.

After Britain reversed its industrial policies in 1980, productivity growth in Britain rose well above the world average. It is not surprising that the government's policies, once they were reversed, produced high productivity growth in industries like automobiles and steels where productivity growth had been lagging in Britain. The reason is that industrial policy, as it was practiced in Britain, and as is likely to be practiced here, encouraged overmanning to hide unemployment. When the discredited policies came to an end, unemployment rose very rapidly. Unemployment which had previously been hidden by overmanning British Telecom, British Aerospace, British Airways, British Steel, British Leyland came to light. When policies changed the measured unemployment rates rose dramatically, but productivity in the industries that were freed of overmanning also rose quite dramatically.

Finally, there is the neglected issue of freedom. Even if it could be shown, and I do not believe that it can, that, on average, industrial policy would make marginal improvements in our real standard of living, we should be unwilling to sacrifice our freedom to decide, to spend, to produce, to set wages and prices, and to allocate capital. Many countries that have adopted industrial policies—France, the UK, Japan in the fifties and sixties—imposed controls on capital movements. Formal or informal controls on prices, wages and interest rates are common where the state imposes its judgment in place of the market. These restrictions on freedom not only reduce allocative efficiency; they restrict the rights of individuals to allocate their income and express their individual judgment.

Much can be done to improve the functioning and performance of the world economy. We should not be satisfied with our current performance and we should continue to reduce regulation of financial markets, trucking, telecommunications, railroads, and other regulated industries. The promising start toward procompetitive policies has been followed by a slower, more hesitant approach. We should go back to the policies which encourage efficiency.

The third table of my prepared statement shows the excessive variability of monetary policy during the past 6 years. This variability places an excess burden on the economy by changing signals from stop to go, from go to stop, and from slow to start. It is not difficult to understand that following a monetary policy of this kind, or policies of this kind, which give different signals to the economy, that we would have slower growth in capital investment. No one knows whether he's planning for an environment in 1985 or 1986 that will be back in recession or back to inflation. No one knows, looking at these rates of growth of money and the corresponding rates of inflation that would follow them whether, in fact, the best thing to do is to squirrel your money away in gold or silver or diamonds or to invest in plant and equipment. More stable monetary policies are a critical element in a macroeconomic policy oriented toward stable growth and high levels of unemployment.

Current procedures for monetary policy expose the economy to continuing risks of alternating periods of excessive monetary expansion, followed by excessive monetary contraction. Estimates are that the variability of money growth has raised interest rates at all maturities by 1 to 2 percentage points. Lower variability would permit interest rates to decline and encourage investment in capital formation and raise the level of income.

The present period of comparable rates of inflation in the major countries offers an opportunity to increase the stability of the world economy, reduce world inflation, and increase the stability of exchange rates and thus, increase trade and capital investment.

These desirable goals can be achieved without fixing exchange rates if principal countries agree to adopt consistent monetary policies that encourage growth and low inflation on a worldwide basis.

Based on current economic forecasts, budget deficits in the range of $175 to $200 billion can be expected in the fiscal years 1984 and 1985, and continuing through most of the rest of the decade.

Current deficit projections constitute a policy of future deindustrialization. Financing the U.S. deficit absorbs savings from the rest of the world. The other side of this capital transfer is an enormous U.S. trade deficit. Business and political leaders conclude wrongly that U.S. goods cannot compete in world markets. They urge protection and industrial policy to slow imports and subsidies to encourage exports. These recommendations are based on an incorrect diagnosis of the problem. Tariffs, protection, and industrial policy will not eliminate the problem, but will reduce efficiency, further misallocate resources, and lower standards of living. Reversing the current deindustrialization requires lower government spending. This is the proper solution to the budget deficit and the trade deficit.

Growing restrictions on international trade in agriculture and manufactured goods reduce opportunities for debtor countries to earn foreign exchange. These restrictions lower standards of living in debtor and creditor countries alike and prevent the debtor countries from earning the resources for investment. Thus, the policies lower output and living standards.

The United States should take the leadership in international economic policy, as it did in the forties, by calling for another round of phased reductions and barriers to capital movements and reduction of quotas, tariffs, and the restrictions affecting trade in agricultural and manufactured goods. A major source of world economic growth during the fifties, sixties, and seventies has been the expansion of world trade. If we end the expansion of world trade, or hamper it, we hurt ourselves as well as others.

If policies to increase stability in monetary policy, to reduce the budget deficit by cutting government spending, to expand world trade by reducing tariffs, quotas, and restrictions on capital movements are adopted, I believe the United States can return to a more sustained growth with slow inflation, while maintaining freedom. Thank you.

[The prepared statement of Mr. Meltzer follows:]

Prepared Statement of Allan H. Meltzer

Industrial policy is defined in the Chairman's letter of invitation as the coordination of Federal fiscal, monetary, trade, regulatory, anti-trust and R&D policies. Coordination would be achieved by an organization like Japan's MITI. A related proposal calls for the creation of a government development bank to lend money at below market rates of interest to fast growing firms in technologically advanced industries, for the purpose of encouraging growth, and to firms in declining industries with the intention of smoothing the decline.

I believe that the proponents of industrial policy (1) misinterpret the recent industrial history of the U.S., (2) misunderstand what has happened in the world economy, and (3) misread the experience with industrial policy elsewhere. Further, this type of industrial policy is insuitable in a society of free men. Industrial policy shifts control of resource allocation and investment from the market place to government agencies and delegates decision making power to political appointees allegedly representing labor, capital, consumers and other interest groups. This method of allocating resources is more suited to a corporate state, like Italy under Mussolini, than to an economy that seeks to achieve efficiency and freedom. Countries with industrial policy typically restrict capital movements and regulate interest rates as in Japan during the fifties and sixties, in Britain until 1980, and in France today.

My opposition to industrial policy does not mean that I believe current arrangements are ideal. I do not. Changes are needed. I offer some proposals for changes after commenting on industrial policy.

Recent Industrial Experience of the U.S.

The typical brief in favor of industrial policy attributes our slower growth to a lack of planning. A typical claim is that the United States has been "deindustrialized" by growing competition from foreign countries and by their ability to increase their industrial production by diminishing ours.

These claims are not correct. We have not been "deindustrialized". The growth rate of industrial production in the United States slowed in the seventies. But, as Table 1 shows, all major developed countries experienced slower growth in the seventies.

Table 1
Growth Rates of Industrial Production

	1963-72 (1)	1972-81 (2)	Percentage Decline (2)-(1)	Rank
Belgium	4.4	1.2	73%	7
Canadian	6.1	2.6	57	3
France	5.3	1.6	70	6
Germany	4.9	1.1	78	8
Italy	5.1	3.2	37	1
Japan	12.0	3.6	70	6
Netherlands	6.5	2.1	68	4
Sweden	5.1	0.7	86	9
Switzerland	4.6	0.3	93	10
United Kingdom	2.8	-0.2	107	11
United States	5.1	2.6	49	2

Source: Federal Reserve Bank of St. Louis, *International Economic Conditions* June 1983.

Growth rates for industrial production show that, during the period 1963 to 1972, U.S. industrial production rose at a rate comparable to the growth rates experienced in the developed countries on the European continent, but that rate was less than half the growth rate of industrial production in Japan. In contrast, during the nine years ending in 1981, growth of U.S. industrial production is above the average for the developed, industrial countries.

All the developed countries experienced a decline in the growth rate of industrial production during the seventies. The oil shocks, rising inflation, rising protectionism, increased taxation to support consumption and transfer payments and increased uncertainty about monetary, fiscal and trade policies are prominent among the reasons offered to explain slower growth. Whatever the reasons, it is clear that the U.S. has not suffered a relative decline.

Table 1 shows that the percentage decline in the growth of industrial production in the U.S. is smaller than in most developed countries. Japan experienced a much larger relative and absolute decline in growth. On average, the growth of Japanese industrial production is now much closer to the U.S. rate of growth.

Differences in the timing of recessions and recoveries in specific industries and other well-known problems of cross-country comparison suggest that we should not overstate the importance of small differences. Changes in the starting or ending dates would probably alter the relative rankings. Such changes are unlikely to alter the two main conclusions I draw: First, the decline in growth rates affects all developed countries; Second, Japan did not avoid the world problem but, in fact, the Japanese growth rate declined relative to United States'.

Data for real income include income earned in the provision of services, in agriculture and other productive activities. These data, shown in Table 2, support a stranger conclusion. The U.S. has the smallest relative and absolute decline in growth of real income among the eleven developed countries. Japan has the largest absolute decline and one of the largest relative declines. Japan's record of growth is impressive, but the differences in growth rates between Japan and the U.S. have become smaller. Whatever MITI or Japanese policy achieved, it did not prevent a decline in Japanese growth toward the world average.

Table 2
Growth Rates of Real National Product

	1963-72 (1)	1972-81 (2)	Percentage Decline (2)-(1)	Rank
Belgium	5.0	2.3	54%	8
Canada	5.6	3.3	41	3
France	5.5	2.5	54	8
Germany	4.5	2.3	49	5
Italy	4.5	2.9	36	2
Japan	10.5	4.4	58	10
Netherlands	5.4	2.8	48	4
Sweden	3.8	1.8	5.3	6
Switzerland	4.1	0.8	80	11
United Kingdom	2.8	1.3	54	8
United States	4.0	2.7	32	1

Source: See Table 1.

Changes in the World Economy

In a competitive economy with freedom to transfer capital to countries where anticipated returns are highest, the less developed countries typically acquire capital from the more developed countries. The flow of capital, if invested in efficient enterprises, reduces the difference in anticipated returns, increases income in the less developed countries and reduces differences in real wages between more developed and less developed countries. Measured growth rates would probably rise in the less developed countries, for a time, reflecting the increase in their level of income. If the process continued without hindrance, real wages and real rates of return would, eventually be equalized and incomes would move toward equality.

In practice there are many reasons why wage rates, incomes and rates of return are not equalized. Risk and uncertainty of return differ, and the differences are reflected in premiums that affect interest rates across countries and over time. Tax rates, regulations, social customs and attitudes differ also.

The tendency of capital to move toward highest after-tax, risk-adjusted real rates of return and for real wages to rise rapidly in market oriented, developing economies is clearly shown by the data for recent years. Japan, Taiwan, Korea, Malaysia (and other developing countries) have imported capital from the more developed countries by providing higher anticipated rates of return. The opposite side of this capital movement is that the developing countries export more goods and services than they import.

The fact that countries like Japan, Korea, Taiwan or, in its better days, Brazil move from technologies that are more labor intensive (textiles) to technologies that require more skill and have greater productivity per hour (microprocessors) or to technologies that are labor saving (robots) is the expected result of development. Growing competition in industries with advanced technologies is the expected outcome of world economic development and is not, by itself, evidence of a failure in the U.S. The fact that Japan now produces computers and that Brazil now produces airplanes, to choose two examples, is evidence of the remarkable advance in the market economies of the world during the past thirty years.

These achievements impose costs and benefits on us and others. We are forced to change, to become more efficient, to adopt new methods and to develop new products. As we become more efficient, our living standards rise.

Proponents of industrial policy see the world as a mixture of "sunrise" industries and "sunset" industries. This is misleading and sustains the absurd belief that someone "knows" which are the sunrise and which are the sunset industries or that the former should expand and the latter close.

Production of ceramics is one of the oldest industries in the world, but it is currently a growth or "sunrise" industry. Rubber tires production is an old industry, but new technology and new products have produced remarkable changes in the quality of tires, in their safety and in the number of miles travelled per tire. These examples can be expanded almost endlessly. No one can predict when product or process innovations will make a "sunset" industry into a "sunrise" industry or conversely. The great advantage of the market is that it does not concentrate decisions in the hands of experts or community groups but gives opportunity to those who are willing to risk their time, talent and money when making investment decisions.

Public policy has encouraged – and despite some increase in trade barriers, continues to encourage – expansion of world trade and growth in the market economies of the world.

Japan, Taiwan, Korea and others could not have implemented successful policies based on export-led growth, if the U.S. and other countries had not accepted the growth in imports required by these policies. Had we failed to accept their imports, the exporting countries would have been poorer, but we would have been poorer also.

In the two decades following the end of World War II, real per capita income probably increased at a higher rate in more countries and for more people than at any time in recorded history. This progress continued in the seventies, but at a slower rate. We should not abandon the strategy that produced these gains. On the contrary, we should make a concerted effort, to adopt policies that encourage efficiency, enterprise, initiative and policies that remove barriers to world trade and capital movements. We should encourage the rest of the world to do the same.

The Record of Industrial Policy

The typical tract on industrial policy concentrates on Japan and argues that Japan grew rapidly because (1) Japan had MITI and (2) MITI pursued a coordinated industrial policy. Critics of industrial policy typically point to the experience of Britain and the recent experience of France and point to the logical (*post hoc*) fallacy that gives credit to MITI because MITI was there.

Experience in Japan, by itself, tells us nothing about industrial policy. No one should be surprised that some government decisions prove to be insightful, perceptive and correct. It would be surprising if *all* government decisions were wrong or foolish and *all* private decisions correct. If this were true, serious people would not consider industrial policy or government planning and direction of investment.

The comparison of a free market strategy and government planning and directing must be based on the total record, not on specific instances of success or failure. The record of industrial consolidation, state direction of investment in Britain is miserable. Table 1, above, shows that Britain is the only developed country with stagnant or declining industrial production in the seventies. After these policies were reversed, in 1980, productivity growth rose well above the world average. No doubt some of the increase in U.K. productivity growth is cyclical, but some of the increase is the result of the change in economic policy from industrial policy to a more market oriented policy.

France has recently forced industrial consolidation, the coordination of research and has increased state direction of investment. French governments have always had considerable influence on credit allocation, and government influence has increased. It is too early to reach a final judgment about the results of this experiment with industrial policy, but the early results are not encouraging.

Further, there is the often neglected issue of freedom. Even it could be shown – and I do not believe it can – that on average industrial policy would make a marginal improvement in our real standards of living, we should be unwilling to sacrifice freedom to decide, to spend, to produce, to set wages and prices and to allocate capital. Many countries that have adopted industrial policies – France, the U.K., Japan in the fifties and sixties – imposed controls on capital movements. Formal or informal controls on prices, wages and interest are common where the state imposes its judgment in place of the market. These restrictions on freedom not only reduce allocative efficiency, they restrict the rights of individuals to allocate their incomes and express their individual judgments

Some Suggested Reforms

Much can be done to improve the functioning and performance of the world economy. We should continue to reduce regulation of financial markets, trucking, telecommunications, railroads and other industries. The promising start toward pro-competitive policies has been followed by a slower, more hesitant approach.

Other useful changes should be made to reduce uncertainty about future monetary, fiscal and trade policies. At its recent meeting, the Shadow Open Market Committee recommended a set of policies that is far more likely to raise real incomes and reduce inflation than any set of proposed industrial policies or other schemes to transfer control of resources from individuals and firms to government agencies. In the following paragraphs, I borrow heavily from the Shadow Committee's September statement.

Monetary Policy

Currently, there is widespread uncertainty about future monetary policy. Will the Federal Reserve be excessively expansive or two contractive? No one can be very certain as long as monetary growth swings over the wide range experienced in recent years and shown in the table.

Quarterly Periods	M1	Monetary Base	Policy
Q4/77-Q4/78	8.2%	9.3%	GO
Q1/79	5.6	7.1	SLOW
Q1/79-Q3/79	10.3	8.6	GO
Q3/79-Q2/80	2.2	7.4	STOP
Q2/80-Q4/80	13.3	9.5	GO
Q4/80-Q2/81	7.1	7.2	SLOW
Q2/81-Q4/81	3.2	4.4	STOP
Q1/82	11.0	10.1	GO
Q1/82-Q3/82	4.7	7.4	SLOW
Q3/82-Q2/83	13.8	10.3	GO
Q3/83-?			SLOW
Averages	7.9	8.0	

Current procedures for monetary policy expose the economy to these continuing risk of alternating periods of excessive monetary expansion followed by excessive monetary contraction. The estimates suggest that the variability of money growth has raised interest rates at all maturities by 1 to 2 percentage points. Lower variability would permit rates to decline and would encourage investment and capital formation and raise the level of income.

The present period of comparable rates of inflation in the major countries offers an opportunity to increase the stability of the world economy, reduce world inflation, and increase the stability of exchange rates and, thus, increase trade and capital investment. These desirable goals can be achieved without fixing exchange rates if principal countries agree to consistent monetary policies.

The governments of the United States, Germany, Japan and the United Kingdom should agree to set the growth rate of the monetary base equal to a moving average rate of growth of real output with adjustment for a moving average growth of base velocity. A policy of this kind would bring relatively stable prices in all countries and would increase the stability of exchange rates. Further, it would provide a disciplined approach that is easily monitored. It would provide targets that even central banks could achieve and would facilitate a gradual adjustment to changes in relative rates of financial intermediation.

Fiscal Policy

Based on current economic forecasts, budget deficits in the range of $175-200 billion can be expected in fiscal years 1984 and 1985. A continuing stream of deficits in this range is likely for the rest of the decade. These deficits reflect the continued high level of government spending. The path of total government spending for the remainder of the decade will be largely determined by spending for defense, pensions (mostly social security), and health care services. Together with interest on the debt, outlays on these programs will account for about 80% of total government spending in the future. Congress and the Administration should reduce the growth rate of real Federal outlays on these programs below the rate of sustainable GNP growth. This would require a re-examination of the defense spending path, and significant structural reforms in retirement and health programs.

Current deficit projections constitute a policy of future *deindustrialization*. Financing the U.S. deficit absorbs savings from the rest of the world. The other side of this capital transfer is an enormous U.S. trade deficit. Business and political leaders conclude wrongly that U.S. goods cannot compete in world markets. They urge protection and industrial policy to slow imports and subsidies to encourage exports. These recommendations are based on an incorrect diagnosis of the problem. Tariffs, protection and industrial policy will not eliminate the problem but will reduce efficiency and further misallocate resources and lower standards of living. Reversing the current deindustrialization requires reducing government spending. That is the proper solution to the budget deficit and the trade deficit.

Trade Policy

Growing restrictions on international trade in agricultural and manufactured goods reduce opportunities for debtor countries to earn foreign exchange. These restrictions lower standards of living in debtor and creditor countries alike and prevent debtors from earning the resources for investment. Thus, the policies lower output and living standards.

The United States should take the leadership in international economic policy by calling for another round of phased reductions in barriers to capital movements and reductions of quotas, tariffs and other restrictions affecting trade in agricultural and manufactured goods.

Representative LUNGREN. Well, thank you, Mr. Meltzer. Again, I want to thank you, along with all the panelists, for the quality of your presentations. This has been one of the most interesting panels we have had.

Mr. Weil, as I understand your position, you suggest that the United States needs—well, the United States already has somewhat of a complex set of micropolicies which basically present a need for coordination, for which you can use the rubric national industrial policy or something.

Is that the essence of your concept of the need for an industrial policy and what it ought to be? The reason I ask that is some who suggest we need a national industrial policy talk about it in more stark terms. They suggest that we have a new period of rapid technological change and the threat imposed by increasing imports. Those two things together make the present situation so different than anything we have seen before, that that necessitates a new response on the part of the Federal Government.

And what I am trying to get at is do you share that view or is your view a more limited view that we already have a number of small industrial policies and we need something to tie those together?

Mr. WEIL. Well, I think that the latter way you expressed it describes the essential element of what my view is. I would not disagree, however, that there are other reasons why this smoothing or coordinating mechanism is useful. We are facing a very serious protectionist threat in this country, and protectionist threats elsewhere, because of the fact that this is the third year in a row in which world trade will have declined.

I would remind all of us that until these last 3 years, world trade during the seventies and even in parts of the sixties grew at a rate faster than almost any of the constituent economies that comprised it. I would agree with Mr. Meltzer that we want to insure that we do not allow ourselves to fall back into any pattern of protectionism, as in the thirties. There is a real risk that we might do that. As you well know, in this Congress, there is some serious protectionist legislation which has very real promise of becoming law. Some of that legislation with respect to targeting, for example, which would prohibit any country from doing anything that would coordinate their activities. That legislation could do more damage to the world economy than Mr. Smoot and Mr. Hawley did in 4,000 amendments in 1930.

But to answer your question, yes. What I see that we are missing is the ability in our governmental process to deal with the applications of micropolicies. Where I think I primarily differ from my economist friends—and I am not an economist, though I have lived a lot with them in the last 25 years—is that I have a comprehension of how private business decisions are reached, because I have made them for years.

For the first time I think, perhaps in the history of this country, there is a course being taught in a major university, in a school of public policy, on private decisionmaking. That is the Kennedy School of Government at Harvard. Unhappily very few economists, and very few public policymakers today understand how private business decisions are reached. And, certainly, very few private business decisionmakers will understand how public decisions are reached.

We have to do something that gets at the core of that.

So the answer to your question is essentially, yes.

Representative LUNGREN. Let me ask this, and I do not want to necessarily go on record, or not require you to go on record with respect to any particular proposal that has been presented to the Congress. Congressman Lundine has been an active proponent of these and other types of national industrial policy initiatives and he has said that although the economic cooperation council, as he would envision it, would only be advisory, he said this—he said that its recommendations would carry enough weight to cause political and economic, and these are his words, "economic peril", to those who ignored its recommendations.

Do you share that type of an approach for a council? And if you do, do you share the optimism that such a council could carry that weight? And I guess my last part of that would be if it does carry that weight, how is it necessarily insulated or isolated from political underpinnings as opposed to economic underpinnings?

Mr. WEIL. Well, as far as the weight is concerned, new institutions in this country have been developed regularly and have acquired their weight often by slowly acquiring credible regulations. By the way, I would remind those of us who say that we cannot do these things because we cannot change our system, that we have been meeting changes and challenges for 200 years and inventing new institutions to do it. To sit here today and to say that that cannot be done, I think, is to take a most pessimistic view of our governmental process and of the future of this country.

We may not agree as to whether there is a problem that needs to be addressed, but if we were to agree that there is any kind of a problem that needs to be addressed then we may agree that a new systematic approval would help. By the way, I disagree with Mr. Meltzer, who says that markets coordinate. Markets do coordinate to some extent. What they do they do slowly. But, they do not coordinate the policymaking process. And that is what is in need of coordination in this increasingly competitive world where change is even faster.

I would go further than Mr. Lundine, before whom I testified very recently. I feel that a body should be more than purely advisory, because I think purely advisory bodies tend to get ignored fairly quickly.

In order for a body to be useful, it needs to have enough power, used in the contained sense that I spoke about earlier, and enough money to get people to do business with it.

I remind you that in 1913, when the Federal Reserve System was created, there had been a panic in 1907. This country debated what to do about a whole series of financial panics which had preceded 1907 in which only the market was the adjusting mechanism. Finally, the public policy process of the country thought that the time had come to try to have some kind of a central bank. Then it took from 1913 to 1934 for the Federal Reserve to become the lender of last resort. It has taken us 70 years to embroider something which is still controversial, but which is, nevertheless, doing a useful job in the financial sector of our economy.

All I am saying is that I think we should look at the need, which is in addition to macropolicy needs, for some kind of coordinated mechanism which goes beyond the ability of the Congress that cannot deal with these things in a detailed way, and the executive branch, which deals with them, in my opinion, on too much of a political basis.

Charlie Schultze says watch out, a body like this will become a mechanism for protectionism. I would say, watch out, for if we don't have some kind of a mechanism like this, we will have protectionism, because the body politic is saying, "do something." And the only two choices in doing something are to re-erect barriers at our borders to protect these many industries where there has been structural deindustrialization, the macrostatistics of the country notwithstanding. The simplest political response would be to put up a border barrier, say 15 percent, whatever it may be, and put a tariff on motorcycles, whatever it is. And the other possibility is to smooth the micropolicies to try overall to avert that in such a way as to create enough additional employment that there won't be the political need for it.

Representative LUNGREN. Do you want to respond, Mr. Schultze?

Mr. SCHULTZE. Yes. Let us see—first, I hate to come out against motherhood, but I am about to come out against coordination.

I agree with Frank Weil that there are a lot of policies that the Federal Government now pursues that have important—these are micropolicies—that have an important impact on industry. They tend to distort our economy. They tend to cause it problems. But what we do not need to deal with that issue is more coordination.

Now let me explain in just a couple of minutes. First, if you think about it, I think that there are two kinds of policies involved. One, there are policies that are legitimately designed to achieve some major national objective like building our strategic weaponry, environmental control, worker safety and the like, where, necessarily, what the Government does affects some industries more than others.

And the principle here ought to be we should do everything we can to make sure we look at the benefits and the costs. And we very often have not looked at the costs.

What the principle ought not to be, however, is that we manipulate those national objectives in the interest of a particular industry or to get a particular industrial structure. Industry ought to serve the national need, not vice versa.

Second, there are those policies where, because of political pressure, or sometimes out of ignorance, we are doing things not to achieve some national objective, but to reward or penalize particular industries—tariffs, the specific depreciation provisions of the recent tax revision. However much liberalizing depreciation may have been a good idea, ERTA introduced substantial distortions among industries. There are all sorts of things that we do with subsidies, for example, for the merchant marine, to distort industrial structure. And there the answer is not coordination, but elimination.

Let me go on.

Whatever we need to do with this, maybe to look at costs as well as benefits better than we do, or to get rid of some of the distortions, we ought to have a principle of not organizing our efforts by industry structure. It seems to me that the last thing we want to do is to have a process which looks at the economy from the point of view of particular industries—steel, textiles, aluminum, whatever.

Adam Smith said it, I guess, first—that these people never get together without figuring out how they can raise their prices. [Laughter.]

Inherent in organizing by industry is to want some extra market power—protection, tax breaks, subsidy, monopoly power, regulatory advantages.

Inside the industry, labor and management may fight like the devil over how to divide the pie, but when they get together, they want the taxpayer to provide a bigger pie. That is why we do not want a DITI here, in this country. We do not want to put our international trade policy and what studies we do of industry in the same place.

Therefore, yes, we do have all kinds of micropolicies and structural problems that arise out of micropolicies that either were not considered well in the first place and/or ought to be eliminated, but no, we ought not to try to organize our efforts to go at that by industry line, with some structure for industrial policy either within the political system or extra to the political system.

Yes, we need reform. Yes, we need a lot of things done. No, we do not want to have industry-by-industry councils and then some overall group to look at the problems of the American economy with the interests of particular industries in mind.

That we do not want.

Mr. WEIL. Just one point of clarification, if I might. I hope that I did not mislead Charlie Schultze or you into thinking that I suggest that this should be organized along industry lines. I do not. The fact that industries will be considered as part of the process is obvious. But it should be organized along the lines of looking at the whole economy, and not coming, as you would suggest, Charlie, and bringing a particular industry's needs to the front. It looks at the whole thing and balances it off.

I did not mean to intervene. Thank you.

Representative LUNGREN. Congressman Hamilton.

Representative HAMILTON. Thank you. I agree with your observation, Congressman Lungren, that this has been an excellent panel. I begin, I guess, from the perspective of having some skepticism about the industrial policy, although my question at the moment may not sound like it. One of the things, it seems to be, that all three of you have in common is a rather deep distrust of the ability of the democratic political system to make the decisions in this area.

Mr. Weil, perhaps a little less so than the other two. You favor the market making the decision, or something else. Mr. Weil talks about some kind of a political coordinating body, but he wants to insulate that from the ordinary political process, which I interpret to mean the Congress.

Mr. WEIL. No; the executive branch, too. [Laughter.]

Representative HAMILTON. Now the fact is that if you do not do something, we are going to be making the decisions. Despite all of the rhetoric that you have about the market, when industries get into a crunch, they come to us to solve the problem, or to help solve it. You get some magnificent speeches by executives from the steel industry about the market. But when the steel industry is in trouble, its representatives come here. The same thing is true of the automobile industry. And you can go on, and on, and on.

So the result is that the decisions are made here in an ad hoc way. So, although I have a lot of skepticism about the idea of industrial policy, I also see some attraction in what Mr. Weil is saying. He is saying that you have to have some kind of coordination. If you do not have that coordination, then what happens is that those who have the biggest political clout get the goodies and get the benefits. And if you are Chrysler, and you can organize the whole Congress, you get the assistance. But if you are the little guy out here and you do not have that political clout, you cannot do it.

So there is a lot about the way the ad hoc system operates that bothers me a great deal. How do you get rid of this ad hocism? I mean, that is the other side of the coordinating question, it seems to me. Does this not produce a very uneven kind of a policy?

Mr. MELTZER. Is that addressed to me or——

Representative HAMILTON. Anybody. I need help from anybody.

Mr. MELTZER. Let me say that I agree very much with what you said. It is an imperfect world. Economics and politics are both going to be involved. The basic answer to your question is resist. That is all we can tell you—resist. People are going to come here. You can read back the speeches to them that they read to you, but you hear your constituents out there saying, you know, we had better do something. We cannot afford to see Chrysler, or the steel industry, and so on, fail because that means our jobs and all the rest of it.

With foresight, we can recognize exactly the kinds of pressures that you are going to get. You are not going to hear from small manufacturers who want to start out in the high-tech industries. They may send a consul down here to get their taxes reduced, the same as any other industry does. But, by and large, they are not here looking for help. You hear from people who have a problem.

But what would this agency hear from? They would hear from the groups in distress. There is not any magic formula that is going to bypass the political process in the country, nor should we hope to find one. We all believe that it has some virtues. And that process is going to be operating on Mr. Weil's agency, just the same as it is going to be operating on a Congress. And if it does not operate on that agency, then the Congress is going to see that it operates on that agency because that is what your constituents are going to want you to do.

That is why we want to with Mr. Weil's coordination. We are not going to achieve perfection and have a world which is going to be tightly organized into the Government only making decisions about public goods like defense and police protection and some income redistribution on one side, and the market doing everything else. We have a mixed system. We want to recognize that in that mixed system, the pressures come on the Congress. You want to have as few new agencies to buffer those pressures and accede to them as we can possibly have.

And that is why I think this is a bad idea within the present political context, not just from the standpoint of economic theory. We want the market to operate as well as it can in the mixed environment we have created.

Mr. SCHULTZE. I do not have anything very specific to tell you. I guess if I knew the answer to your question, I would run for president.

Representative HAMILTON. You might not get there. [Laughter.]

Mr. SCHULTZE. I understand that. But it would be worth trying if I had an answer to that question. [Laughter.]

First, it is clear that the Federal Government, the Congress, the Executive, does all sorts of things, some wise, many not so wise, which have major impacts on the structure of our economy.

No. 2, the only thing that I want to stress is that coordination is not the problem. There are some principles that we ought to operate on. It is not just one principle. There are a number of principles in the area of how does Government best go about regulating industry from the point of view of environment, safety, and health. That kind of thing.

And I think very often, they are honored in the breech as to how we have gone about it.

There are some principles, I think, about dealing with the problem of industry bailouts, when you do it, when you do not do it. I will not go into the details, but I think that there are some principles. That is pretty much a separate set of problems.

It may very well be that we could change, make some modifications in our processes. For example, within the executive branch and the Congress, I am not at all convinced that the process is now set up to deal with the very difficult longrun problem of how you most efficiently regulate industry from an environmental standpoint. I do not want to suggest that we could not change. All I am saying, what you do not want to do is assume, A, that coordination is going to do it, where you put everything all together and get recommendations out of one body. Why not look to the Council of Economic Advisers or OMB already? And/or B, the thing you do not want to do, I think, is look at it principally from the point of view of how do we help industry. What you want to do is look at it in terms of how do we best get a most efficient intervention when we do decide to intervene.

Representative HAMILTON. It seems to me that the bottom line of all of this talk about industrial policy, at least for those of us sitting where I sit, is jobs. That is what you are really talking about. And the reason that we are under so much pressure up here is because people are worried about not just the question of whether there is going to be a job. That is a key question—but another question is what is that job going to pay? And people are worried that as they go through this transition, or whatever it is that we are doing to the economy, about whether enough jobs can be generated and whether those jobs are going to be such that they will provide a decent standard of living.

Now, if you just say that Government's job is to get the right mix in macroeconomic policy, that is not very persuasive to these people. They are not going to buy that. I have been in the Congress for 20 years. We have never had the right mix in macroeconomic policy. [Laughter.]

I have never seen the day when we have had it. We are always striving for a better mix of policy. And you still have these people wanting jobs out here and wanting jobs at a better level.

Now what do you tell them about whether or not we are going to be able to generate jobs in this economy?

Mr. WEIL. I will take a piece of a whack at that, Congressman Hamilton. I would like to go back, if I might, to your former question, too. I would like to make certain that even though I purport to have an answer, I am not running for President, and would not under any circumstances. [Laughter.]

Let us take one example of coordination. Charlie is very good at phrases that undercut by saying, for example, that industrial policy is a solution in search of a problem, and that coordination is motherhood. But, motherhood was not so bad or none of us would be here today, so I am for coordination despite Charlie.

When I was Assistant Secretary of Commerce and Charlie was in the august position of Chairman of the Council of Economic Advisers, and the then Chrysler executives were padding around this town in the fall of 1977 and the early part of 1978, they went everywhere. They went to the Treasury, to the Commerce Department, to the State Department, to the Council, to the Labor Department, to the Department of Transportation, and everybody heard out their problems. Their problem was really quite simple. Their problem was that mileage and emission requirements were going to get Chrysler into the kind of trouble it got into. They pleaded: "Do something."

Everybody looked at everybody else and said, what can we do? You do something.

I remember calling my counterpart in the Department of Transportation—I described my understanding that the essence of the problem was that if Chrysler was obliged to meet the mileage and emission requirements that were then the law on schedule they would not be able to afford it and they would go broke. I added my personal view that if they went broke, certain consequences would follow.

I asked my counterpart at the Department of Transportation if we could not look at this problem from a broader point of view? And his answer was no. The law says that we must apply these mileage and emission requirements by certain dates and we have no obligation or requirement to do otherwise. We would be politically crucified if we did anything else. The broader economic issues were not his responsibility.

There was no place in this Government to go until the Chrysler crisis was on the verge of bankruptcy. Then they came to the Congress. Most of my friends in the Congress have said since then that never again do they want to try to have to deal with that kind of problem. They felt that such problems should not be dealt with in the Congress. They should be dealt with somewhere else.

There was no coordination. There was a lot of information; there was no knowledge. And there was no part of either the executive branch of the Congress that was able to really concentrate until it was nearly too late.

It is amazing that in fact, Chrysler probably was saved I say, probably, because the evidence is not all the way home yet. They are doing well at the moment but the deficit crunch has not hit home yet. It would be a lot cheaper in the longer run to get ahead of our problems. As it turns out, Chrysler was saved with no outlays of money because it was saved with only an arm around the shoulder. That has been eliminated, with a profit to the Treasury for the options given the Government for the risk taken.

Then as Congressman Lungren said a few minutes ago, or you did, Congressman Hamilton, there are a lot of little companies that are not going to get anybody's attention, much less any one part of the executive branch. And, despite Charlie Schultze's clever way of saying coordination is motherhood and therefore, we do not want it, or we should not want it, because we get misled by it, I strongly take issue with that. We have got to coordinate. The kind of coordination that I would like to see us have I do not think can take place in the executive branch as it is constituted today, or in the Congress as it is constituted today.

I would also remind you of one other thing and then I will be quiet.

Mr. SCHULTZE. No, you will not. [Laughter.]

Any more than I will. [Laughter.]

Mr. WEIL. OK. Beginning in the thirties, actually, beginning in the early part of this century when they invented the ICC, we have created what some people refer to as the fourth branch of government. Three years ago, people said, the idea of another governmental mechanism was out of the question, because what this country wants is less government.

Now we have had the benefit of a President who may have finally given a bad name to the expression "less government." More people seem prepared to accept the fact that problems change and institutional requirements change. All I am suggesting here is that we come up with a coordinating mechanism which will be just part of that fourth branch of government, which we used to call the alphabet soup, that mechanism will have to develop its own credibility as time goes by.

Mr. SCHULTZE. Could I respond to that, quickly, I hope, and then to your point about employment?

First, I think, in the case of Chrysler—forget whether the decision was right or wrong—we went about it just the right way. It was ad hoc. To every set of principles, including the ones that I have just tried to lay down, there are exceptions. And what we ought to make damn sure, what we ought to make very sure is that it is hard to get an exception. And that is what happened with Chrysler. You had a special law. You had to convince a majority of 534 people on the Hill, not from Chrysler areas, most of them, that this really was a major national problem.

What would happen if you regularized that kind of assistance, I am afraid, is that you would then make it much easier. As Frank Weil said, small companies find it very hard to get such assistance. They should. It should be a major national trauma—I exaggerate—but it should be a major thing before we do it and ad hocracy is just right.

The same thing with trade policy. We do not always do a good job with trade policy. But we have set up a lot of uncoordinated barriers that firms have to go through to get protection. And if I look back 10 years and if I had then asked myself, where would we be with respect to protectionism with 10½ percent unemployment and with Europe, I think unemployment just as bad, with the Japanese trade surplus the way it is, I would have said that we would have had 10 times more protection than we now have.

In one sense, we have not done a bad job precisely because we made protection hard to get.

The second point with respect to unemployment—small comfort, but it is a fact that with respect to providing employment, there is no country around the world that comes even close to the United States in having done it during the decade of the seventies. Second, we are now having our unemployment rate go down, just as the Europeans are steadily going up. Theirs continues to rise.

Finally, our unemployment, terrible as it is, is far, far less serious than the European. Let me read you a set of—at least when I first saw them—startling statistics. In 1982——

Representative HAMILTON. Let me interrupt you.

Mr. SCHULTZE. Excuse me. I am sorry.

Representative HAMILTON. That gets you nowhere in terms of talking to people out here who need jobs. You can compare it with Europe, Japan, anywhere that you want to. The fact is that they know that they are in a crunch on jobs. And they know that the jobs that are available are no longer down there at the automobile plant where they get so many dollars per hour, but are the ones that pay 20, 30, 40 or 50 percent less than that.

Now they have to have some hope out here. They have to have some belief that this system of ours can produce jobs for people. And right now they are losing that. And when you talk to them about European unemployment rates, which I have tried, that does not get you very far.

Mr. SCHULTZE. My next point——

[Laughter.]

Mr. SCHULTZE [continuing]. My next point will get you even less far. [Laughter.]

Because I guess it would be very difficult to point out that in some cases, at least, there is no way this economy can provide jobs in which the industry concerned has over the past 10 to 15 years raised its wage level relative to the rest of manufacturing by tremendous amounts while our major competitors have not.

You asked me what would I tell people? I do not know, but I would be hard put for me to say that everybody in the country is going to get more than average wages. No way. [Laughter.]

As somebody said to me, most economists agree with all mathematicians—you just cannot do it.

Representative LUNGREN. The only people that can promise that are people in Congress. They do that every election, unfortunately. [Laughter.]

Mr. MELTZER. I would just like to add one thing to that, and ask what does that have to do with industrial policy?

If you look around the world, countries have all sorts of different industrial policies. The United States growth is relatively good. That tells us at least that if we are going to look for a solution to our problem, and we should, we are looking in the wrong place when we talk about industrial policy. We ought to be looking at things that we could do. There is no easy solution that is going to get us down from 9 percent unemployment or 8½ percent unemployment to 5 percent unemployment in a matter of weeks or months.

But there are things that we can do and we should do them. One of them, of course, is, and the one which will help the most, I think, about jobs is what the Congress does about spending and the deficit? Are we going to go to a high-growth strategy which does something about spending and transfers and deficits which will cause us a problem in the future years, or are we going to go to a low-growth strategy based mainly on consumption. The latter means that we are not putting into place the capital that is going to produce jobs at the end of this decade.

I am sure that everybody is surfeited with discussion of the deficit. But, yet, you know, we cannot get into this problem without going back to that same problem of Government spending.

Mr. WEIL. Could I just add one quick point? The shape of where the jobs are is crucial to Congressman Hamilton's question. And I would make the point apropos of Charlie Schultze's argument that we should let the Chryslers be dealt with on an ad hoc basis. Among the Fortune 500 companies, the growth of employment in this country in the last decade has been substantially less than the growth of the next 2,000 companies.

Mr. MELTZER. Good thing.

Mr. WEIL. That is a good thing? But, if we only are going to address the problems of the Fortune 500 because they can be dealt with in political terms, then we may be overlooking a problem that is buried in the smaller companies that are coming forward where the marketplace is doing its thing. We ought to be looking at how the micropolicies are affecting those smaller guys. You hear from them. And we hear it not only from the individual workers, but from the unions, that they are buried in paperwork and they are buried in regulations in micropolicies, some of which represent very important national needs that they need help with. They are not going to get the kind of help that Chrysler got when Chrysler was going broke.

Representative LUNGREN. Let me ask you a question on that. I happen to be one of those who voted against the Chrysler bailout. I still do not think that we have proof that it necessarily is a success, even if Chrysler maintains itself, because I would ask you, what is the proof that that capital, which was redirected toward Chrysler, would not have been better directed where the market would have directed it, created more jobs, perhaps in high tech, but perhaps in the auto industry elsewhere. For a Chrysler, you can get a Lockheed. My own district has McDonnell Douglas. We produce commercial aircraft. We are having trouble doing it, as is Boeing now. And I would argue that by bailing out Lockheed, you, in essence, made both Boeing and McDonnell Douglas less competitive in the long run in the international marketplace.

Now we can argue that for hours, but it just seems to me that the way we went about making both of those decisions was that opposed to having, quote, unquote, "disinterested persons," and I love that concept—I have gone to school long enough to find out that most professors are interested in something that may be related to themselves, and they are displaying one bias or another when they are presented as disinterested parties.

But, nonetheless, would it be better if you could have disinterested parties to come before whatever decisionmakers you have, or require those decisionmakers, as Members of Congress were required under the Chrysler case—I was here then. I assume it was the same under the Lockheed case—were exposed to a variety of interested parties. We did not suffer from a lack of information. We heard from everybody.

Now I did not have Chrysler manufacturing plants in my district, but I had a lot of Chrysler dealers, some of whom no longer speak to me, and a lot of employees who sent letters. And even though I disagree with the Chrysler decision, I thought the ad hoc nature made them really step through the hoops and make a case to us that was an exception.

Now as I understand it, Mr. Weil, you think that that is the wrong way to go about it. My problem with your approach is this. If you institutionalize the process of going to the Government, do you not create in the private sector a greater reliance on getting assistance—you can call it bailout. You can get an informed judgment. You can talk about redirection of capital—but getting some assistance directed by other than the marketplace, is that a good thing?

Mr. WEIL. There is implicit in a lot of these attacks on the positive side of the industry policy argument an assumption that it is going to be a pork barrel, an assumption that it might be protectionist, that it will be the only place to go to solve your problems.

I do not accept that. A lot of the opponents are painting it in sharp negative colors in order to undercut it. Some of that has taken place here today and I understand their point of view and if I was on that side, I suppose I would do the same thing.

I am suggesting something substantially narrower than that. The very narrow point that I think you have got in the nature of the question that you asked in the beginning is that what I would like to see us do is to help smooth the process of the application of micropolicies upon the private business decisionmaker. Not so much to hand out major assistance. There have been some recent articles that have been written that are quite interesting about industrial policy in Japan. People are attacking Japan at the moment for doing a great many bad things, including targeting and industrial policy.

The truth is they do a lot less than we do here in a lot of their industries and they get away with less because they do it on a more efficient basis. Now that also could take a long time to talk about. But the very fact that the Government could be perceived to be the place where you solve all your problems would be a very bad thing. I agree with that.

What I propose here—Charlie's got it right—is coordination. And there is a difference between coordination and planning. There is a difference between coordination and picking winners and losers. And in the middle there is a narrow area where we can do a better job. Now maybe the Congress could do it. Maybe Charlie's right. Maybe an improved Council on Economic Advisers. Maybe another adjunct of the Joint Economic Committee with some kind of a council between the two of them might help. Maybe that is where we will start and that is where some of the proponents are, that we should start with a very modest thing of part-time people on an advisory basis.

And I remind you that with the Federal Reserve System and some other agencies like that, we started modestly. But I think we have to start somewhere because we are not talking to each other collectively as well as we need to.

Representative LUNGREN. Let me ask you this. In constructing any such mechanism, whatever it is—advisory, somebody with a hammer or having an ability to threaten, whatever your concept is of some sort of council—how do you construct a council properly that takes into consideration the diverse needs of this economy?

My fear is, as in many institutions in Washington, you get big government, you get big labor, and you get big business there making those decisions, and yet, when you indicate that the Fortune 500 virtually had a washout in terms of increased jobs over the last decade. And I have seen statistics to suggest that you can take it below the next 2,000 firms—you can talk about that great category that we talk about now, small business, which created the greater part of the employment in this last decade.

Do you realistically believe that we could construct a council which would give full participation or fully weighted participation to the diverse smaller business community as opposed to those very legitimate interests of the larger companies, the larger labor interests, and larger government?

Mr. WEIL. Well, the answer is yes, I think you can. Stan Lundine, as you know, has in mind a 30-member part-time advisory board because he is more concerned with building a consensus and making sure that all those different interests are there. I would argue that we overlook how our governmental system works. We do not like elites in this country. We believe in meritocracy and we are troubled every time anybody is picked for a high office of some sort.

I would remind you that you are an elite and your other 434 colleagues in the House and 100 colleagues in the Senate are also an elite.

Representative LUNGREN. But they can get rid of me every 2 years. How do you get rid of a council?

Mr. WEIL. As the Federal Reserve Board a year ago heard the footsteps that eminated from this building, there are various ways of building into the system checks and balances. But, when we put people on the Supreme Court, on the lower Federal courts, on other courts, when we put people on the Federal Trade Commission or the International Trade Commission, they come with a body of experience. Hopefully, they are people who have capabilities. Hopefully, they are not going to be sitting there as representatives of labor or big business or any particular group and that they will recognize that they are there for a purpose that relates to these issues that we have discussed and that they will think of the country at large.

I believe—maybe I am a cockeyed optimist—that when people are appointed to these kinds of things, they take seriously what their mandate was and they do not come there as advocates. I think one of the benefits of lifetime tenure on the courts, one of the benefits of long terms on the Federal Reserve Board is that people are a little freer to think in the more ecumenical, broader terms.

I think that that is possible. I think that the smaller businessman, the consumer, the people that you are referring to, the unemployed worker, can be better represented in some ways in this process if you have that kind of a system. I believe that that can be done. Now others would disagree, I am sure.

Mr. MELTZER. I would just point to the record in my prepared statement of Federal Reserve policy as a record of the inconsistency of changes in response largely to political pressures and perceived needs. There seems to be a good deal of evidence.

I just do not come out where Mr. Weil comes out. I do not believe that, in a free society, you can set up some agency of wise men who are going to be removed from the political process. Moreover, we do not want to.

Representative LUNGREN. Let me just ask one thing, and I do not want to be beating on you here, but you and I are coming at slightly different positions on this.

We had one of the founders of one of the forerunners of the high-tech field from Silicon Valley come and testify before us. He is very knowledgeable in the area, has been in there for years and years. He said, look, my wife came to me a number of years ago and she said I want to invest in this new little company that is starting up called Apple Computers. And her husband, who was one of the pioneers in the industry, said, you are crazy. They are never really going to do much in terms of home computers. Do not put your money there.

Now he told that story as an indication of how he, intimately involved with that industry, from the very beginning to the present time, continually involved in it, looked at as a leader in that community, had so little idea of where we would be going, and therefore, where capital ought to be flowing, that he told his wife, who was obviously very self-interested in this, that she ought not to do it. And he said, then, how can I suggest that anybody here in Washington or anywhere else within an industry or outside an industry, concerned about workers and so forth, can do a better job, generally speaking, than can the market system.

He basically said, target the entrepreneurial process. Do not target industry or have Government try and make decisions with respect to the flow of capital, the allocation of capital.

What is your response to that?

Mr. WEIL. Well, I am very sympathetic to that. I will tell you that my grandfather made a major investment in the horseshoe manufacturing business in 1907. He might have done a little better if he had picked up one or two of those smaller auto companies at that time. So I am familiar with that problem and it occurs in different ways.

However, Charlie Schultze, I think, will confirm the fact that there are a lot of very thoughtful people in this country as early as the fifties who foresaw many of the developments with respect to changes in energy supplies and prices.

In Japan, in 1979 and 1980, they developed one of their so-called visions. That is an orchestrated process in which they get some 2,500-odd people in academia, government, the whole of Japanese society to participate. They asked, where do we want to be in 1990? And they come up with one point, basically though there were several others. They said that if Japan does not increase its share of GNP devoted to R&D in the next 10 years, it would slip behind the rest of the world.

There have been no directives that have gone forth since that vision was published, but they have already increased substantially their share of GNP that goes into R&D. Could we not try to do something similar?

I would disagree, even though I have in my family history a very bad call, as your friend described his, that it is impossible to assemble information, just in a broad way, into something that resembles knowledge. And moreover, I would disagree with anybody who said that you should not try.

Mr. SCHULTZE. I keep trying to come to grips, and maybe Frank can answer this—what would this council do? For example, right now, I think virtually all—how do I say this—relatively neutral observers who have looked at it would tell you that the current Clean Air Act, with its particular requirement on EPA that you set standards, ambient air standards, requisite for public health with a margin of safety, period, with absolutely no word in there for costs is a problem. We have known it for years. It is a very hot political problem. And they have not done anything about it. The administration just gave up. They were doing nothing.

Query: Is this council going to have environmental powers to change the regulations?

Mr. WEIL. No.

Mr. SCHULTZE. OK. It is advisory.

Mr. WEIL. It might appear, with Congressman Lungren's permission——

Representative LUNGREN. But specifically, how would this council break the logjam that currently exists in the Energy and Commerce Committee of the House of Representatives on the question of clean air?

Mr. WEIL. Well, it is not going to break the logjam because, as I suggested, I think that it should only come in as an intervenor. But an intervenor—I mean, the Fed, when it comes up here to testify before you fellows on certain problems having to do with the deficit, does not break the logjam. But it tells you what its view is if certain things are not done. And what this body might do would be to come up here and say, do you realize the economic consequences of that last 1 percent of cleaning up?

Mr. Schultze made an interesting point in steel. We produce 80 percent of our steel needs today in the United States. We might be headed to 60 percent if the competition were to pull out all the stops. Some part of this Government, and there is none today, ought to be looking at the broader consequences of what happens if that occurs. What to do, exactly is another question. There might be circumstances under which a coordination would try to send signals to the private sector to do certain kinds of things. The truth of the matter is today we do not have a clue what will happen; we do not even try to think about it.

Other countries have had the same problems and I am not suggesting we do what they did. In Sweden, 15-odd years ago they had an argument about what percentage of their shoes they should manufacture. They were still making 80 percent and they were headed down. They got all concerned that they could not make enough shoes if they had to march against the Finns or the Russians in the middle of the winter.

Well, today they make 20 percent of their shoes and so far they have not had to go barefoot. I do not know what percentage of steel we ought to make in this country, but I think that we ought to think about it.

Representative LUNGREN. But my question is, would we think about it in terms of a national industrial policy. The feeling I get is that everyone believes that we have some problems with our fundamental economic decisions. Whether you are from the right or the left, no one is particularly happy about the total mix, no matter what administration is in. I am not sure how you ever break out of that because we all have very strong views on it.

But the sense is, at least I get in some discussion of national industrial policy, that we ought to give up on that and go back to fundamentals. If we just leap over the question of fundamentals and have an overarching concern for national industrial policy, will that take care of the problem?

That reminds me of a football coach coming into a new position where the guys cannot block and tackle and instead of teaching them the fundamentals, he institutes a new offensive system and says, we just have not been coordinating well enough together. We will do this and we will do a better job. Well, if you do not block and tackle, it does not matter how well you coordinate.

A number of us on the Republican side went away for the weekend to try and deal with problems beyond next week. We had a fellow who was with us who deals with change, managing change in industry. He was going to try and help us suggest how we might manage change.

One of the things he mentioned was that he had been a clinical psychologist and had helped in marriages. He used to think the only problem with marriages was lack of communication. And he used to advise people to communicate. He said it was not until years later that he realized they were communicating very well. They both knew exactly why they hated one another. [Laughter.]

And he found out that it was far more than just communication. It was essentially going back to the reasons for it and defining those concerns. To me, that kind of brings us into focus here.

I have no problem with looking at, for instance, the question of the steel industry. I have very strong feelings against protectionism and very strong feelings against protecting an industry where workers get appreciably more than others.

But if there is a national security concern, I have an overall national security concern because it, obviously, affects all of us. It seems to me that we ought to make a decision if there is a national security concern. What is the bottom line minimum steel capacity that we need in this country to provide the basis for a military response if that is necessary? This is a way of looking at that problem, but it is looking at it from a fundamental—which is a national security fundamental. When you make that decision, take into account what the implications are for that industry within the overall economy.

But I take it, Mr. Weil, you do not think that that is necessary—I mean, you do not think that that is adequate, that it would be an adequate response.

Mr. WEIL. Well, first of all, that consideration as to what the national interest is, both from the economic as well as the military point of view, is not being done today. It is not being done.

In today's paper, it was interesting to see that Secretary Baldrige is moving back into the International Trade Administration the microeconomists that were moved out into a different part of the agency in order to bring together a comprehension of what is going on in the microeconomy with respect to trade policy. That is a step in the right direction.

I found, when I was in the Government, that I got calls from people in the White House who suggested change ideas. One of Charlie's sidekicks over there, called me one day and said, you know, what you really need to fix the U.S. trade policy is five more GS–18's. I said that might help, but there is a lot more to it than that.

It is amazing. Maybe the Congress ought to have a look and see what, in fact, is going on in this Government in the way of information collecting and the difference between information and knowledge. I suggest, Congressman, that that may be a good topic to be addressed. When you find out, you will be amazed and you will want to see that something is done. Whether it is done along the lines of what I suggest does not matter. This Government knows less about this economy than the research department of Merrill Lynch.

Representative LUNGREN. Let me ask another question, Mr. Weil. You say that you support the idea of a coordinating council, but you do not support the idea of some sort of bank. Is that correct?

Mr. WEIL. That is correct. I think the bank is a secondary aspect.

Representative LUNGREN. Why do you differentiate there? If you believe that we ought to be making some decisions which carry with it a reallocation of already existing capital, why ought we not to do that directly in terms of some sort of bank? Would you not get more bang for your buck?

Mr. WEIL. No; I think you get too much bang for your buck. I think that is precisely the point. We tend to overkill when we go at things. The banks would get to be very big. It would spend a lot of money. I think we can use small amounts of money to send signals. And I do not think that requires a bank, per se. I think that such a body, ideally, in my opinion, would include an arm that would have some money. I would not call that a bank—money in the broadest sense. An ability to certify certain kinds of tax credits, perhaps, as well as being able to match certain kinds of R&D expenditures, would send signals to the private sector for small amounts of money.

I have had occasion over the last several years to be something of a student of the industrial policy process of other countries. One of the things that is amazing is how much less expensive—not always more effective—their industrial policy process is than ours is today. Because we are so disjointed and ad hoc and reactive, we spend lots more money accomplishing, in many instances, a lot less.

I think a bank would tend to overdo it.

Representative LUNGREN. Mr. Schultze.

Mr. SCHULTZE. If what we are talking about, first, is some independent body with some staff to analyze and present to the Congress the effect of various national policies on the industrial structure, it would be one of the more modest Government wastes of money, but it would not be too bad and it might be useful sometimes. If that is what industrial policy is, I cannot get terribly excited about it.

Mr. WEIL. It has to begin somewhere.

Representative LUNGREN. Well, what is the Council of Economic Advisers supposed to do?

Mr. SCHULTZE. My only point is that this is a modest sort of thing. If we have come to an agreement that we do not want a bank, that, fundamentally, we do not want an independent or a quasi- or semi-independent body with actual active powers to change regulations, to change tax policy, to make loans—if we do not have that, then we are down to a much more modest area of disagreement, but this is an awful lot of noise about a relatively small thing.

It turns out that the Carter administration started—other administrations may have done it, this administration has continued, fairly large-scale industry studies. We undertook a major effort as to what is the impact of governmental policies on the auto industry? I am not saying that it is good, bad, or indifferent. The quality of the studies varied, but they might be very useful.

It turns out, for example, if you look at our environmental policies very, very carefully, they tend to depress newer industries because of the way they are run, while they are easier on older industries. It is worthwhile knowing that.

So there are things that you can do by way of information. I do not particularly think you need some independent body to do it. And I would not be amiss at all at this, but it comes down to a very small thing compared to what the whole industrial policy noise is all about.

Representative LUNGREN. Mr. Meltzer, do we need better coordination of the information that we have already gathered within government?

Mr. MELTZER. I would just add to what Charlie Schultze said and what you suggested. The Council of Economic Advisers is an agency to provide the Congress with whatever information it might require for these purposes. We do not need formal kinds of coordination. We certainly should think about making improvements in a lot of the regulations that we have—the cotton dust standard was one which came through here which probably was decided incorrectly. There are a lot of regulatory policy decisions which are decided incorrectly, I think. That is, without due regard for cost.

We do not need a coordinating agency to try to impose new measures. I think that one of the better parts of the American system is the fact that there are lots of people speaking on these issues, pointing to the problems, making a lot of noise about them and bringing the issues to the extent that they get a hearing to the attention of the Executive and the Congress, which is where, I think, broad issues of this kind ought to be decided.

Mr. WEIL. I think we have seen a little bit of a union at work here and I think it is understandable. Unions are very powerful in this Congress. But this is a union of economists.

I think, actually, if the Council of Economic Advisers had a broader mandate and had amongst its members people who were not necessarily macroeconomists, it would have performed a more useful role in some of these things, and that is not criticism of Charlie, whom I admire enormously. But the Council, by the nature of its history, has tended to look at the economy from a macropoint of view. And I think what consensus is growing is that the economy has, in addition to the macroproblems, an accumulation of microproblems.

Mr. SCHULTZE. Just as a final footnote, it is probably true that the Chairman of the Council of Economic Advisers, Republican or Democrat, spends in terms of time and staff time 75 percent of micromatters and 25 on macromatters. You do not have major fiscal policy decisions every day.

So whether the CEA ought to do it or do more than it does in terms of microstudies, I do not know. It does a good bit now.

My only proposition is that when you start asking yourself, what ought an industrial policy to do, as far as I can see, we are basically down to providing better information on the impact of individual governmental policies on industrial structure.

You know, it is kind of hard to argue with information.

Representative LUNGREN. Well, I want to thank all three of you for appearing before us. This has been one of the more lively discussions that we have had and I want to tell you that it has assisted us in fleshing out this discussion of a proposed national industrial policy. Thank all of you.

The committee stands adjourned.

[Whereupon, at 12:03 p.m., the committee adjourned, subject to the call of the Chair.]

[The following information was subsequently supplied for the record:]

STATEMENT
on the
NATIONAL INDUSTRIAL DEVELOPMENT BANK
for submission to the
JOINT ECONOMIC COMMITTEE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
Dr. Richard W. Rahn*
December 15, 1983

The Chamber of Commerce of the United States welcomes this opportunity to state its opposition to proposals calling for a national industrial policy and creation of a national development bank to facilitate the process of industrial development.

SUMMARY

The Chamber is opposed to proposals for a centralized national economic planning body and for the creation of a national industrial development bank.

- The price mechanism and open markets provide an information system and guides to the most efficient allocation of resources that together are a unique and irreplaceable social discovery.
- The principal reason the socialist economies are so inefficient in allocating resources is their rejection of the free market pricing mechanism, making economic calculation a matter of guesswork or arbitrary decision.
- The economy is recovering rapidly from the recession and it is making the structural adjustments required by technological advances and world market conditions: high technology industries are growing rapidly and mature industries are downsizing, consolidating, and modernizing. These are all market responses to change.
- A federally established bank to assist both mature and emerging industries would assure the misallocation of capital by substituting non-market considerations for market forces.

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*Vice President and chief economist, Chamber of Commerce of the United States.

• No new credit or savings would be created; that which already exists would be reallocated. Capital allocation would be politicized, industries would vie to be categorized as "mature, in need of revitalization" or as "emerging." The winners would be those whose constituencies had the most political clout.

• Small businesses would be at a disadvantage as industries strive to obtain funds from a national development bank; yet, historically, some of the most important innovations have come from small firms.

• Plant closings and unemployment can be traumatic for workers and their families. The Chamber supports assistance for displaced workers through the comprehensive array of federal and state programs already in place, including the Job Training Partnership Act. Special new job creation programs are unneeded.

INDUSTRIAL POLICY: WHY NOW?

Proponents of an industrial policy for the United States claim that it is not enough for the federal government to involve itself in budget, money supply and related issues. It is not enough to provide incentives to work, save and invest. The government must do more -- much more. It must be prepared "to roll up its sleeves and get its hands dirty promoting or discouraging particular industries or even particular firms." And it must create a national bank, patterned after the Reconstruction Finance Corporation, to facilitate the process of industrial development by providing "sufficient funds at reasonable rates for projects deemed worthy of support."

Industrial policy, they contend, will be the panacea for America's economic problems. It will enhance our international competitive position, revitalize our sick industries and encourage the development of new ones. It will increase domestic employment and provide investment capital for tomorrow's products that firms cannot earn on today's production.

All of this, of course, presupposes that the U.S. economy will not remain strong, vibrant and aggressively entrepreneurial without some form of centralized economic planning, and that our nation's high technology industries, upon which so many hopes have been placed, will not survive the strong winds of international competition without significant and pervasive government intervention.

THE PERFORMANCE OF U.S. INDUSTRY

The facts, I submit, do not justify such conclusions.

The U.S. economic recovery has been stronger than most economists had forecast and will remain strong for some time to come. Real output grew by 5.0 percent during the first three quarters of 1983, compared to an average of 4.5 percent for the same period during the past five recoveries. And an expected increase in the real growth rate of about 7.0 percent in 1983 (on a fourth-quarter to fourth-quarter basis) compares favorably with previous recovery experience.

The inflation rate has fallen from over 13 percent in 1979 to 2.9 percent over the past 12 months. The prime interest rate has dropped from 21.5 percent to 11 percent. On the employment front, there are now 102.7 million civilian Americans working, more than at any time in our history, and the unemployment rate has fallen to 8.4 percent, the lowest in two years. And of importance to the issue of concern to this committee, real business fixed investment has risen by 5.9 percent since its low point in the first quarter, reflecting in significant part the Economic Recovery Tax Act (ERTA) tax cuts to spur capital formation. Preliminary estimates of spending on producers' durable equipment point to an almost 16 percent annual rate of increase during the third quarter. Historically, internally created funds have financed the bulk of business investment, and ERTA greatly improved economic profits and corporate cash flow.

In these and other areas of our economy, the Supply Side formula is working to improve our economic well-being.

The U.S. economy, moving from the general to the particular, is also doing well in the high technology area. Nine of the fastest growing U.S. industries are high technology industries (communications equipment, electronic components, aerospace, computers and office equipment, drugs and medicines, industrial chemicals, professional and scientific instruments, engines and turbines, and plastic materials and synthetic resins). The importance of these industries to the U.S. economy may be seen from their disproportionate contributions to research and development and from their large and growing international trade surplus. Such positive factors, directly and indirectly, provide strong "spillover and feedback effects" throughout the entire economy, contributing, in the process, to substantial net job creation.

There has also been a resurgence within our more mature manufacturing sector. Mergers and downsizing in the steel industry, plus extensive modernization, should result in that industry becoming more competitive in the international marketplace. The automobile industry is improving its competitiveness through a massive capital investment program. Automakers expect to invest more than $60 billion over the next five to six years. This sum, in part, was supported by the investment-oriented tax reduction incentives enacted under the ERTA.

In addition, improved productivity performance, more extensive use of robots, greater technological sophistication and a significant backlog in demand suggest a strong come back for the U.S. automobile industry in the foreseeable future. The continuing vigor of the auto industry, often cited as declining in the recent past, should be suggestive of the need for modesty in proclaiming the future prospects of any industry. The key point here is that, like the federal budget, projections for the future should be viewed with great caution.

The performance of U.S. manufacturing during the 1970's suggests that America is not undergoing "de-industrialization" and is not facing the wholesale sunset of basic industries, as proponents of industrial policy so often claim. Charles L. Schultze, chairman of the Council of Economic Advisers from 1977 to 1980, has pointed out that the economic problems we face do not mean that the nation is de-industrializing. To the contrary, he argues that during the 1970s, U.S. manufacturing did quite well compared with other advanced countries. "Total employment grew by 24 percent in the United States during that decade. The next best performer was Japan, with a 9 percent increase. Other countries were far behind; in Germany, for example, employment actually fell. Moreover, the United States was one of only three major industrial countries--Italy and Canada having been the others--with any increase in manufacturing employment."

Much support for a national industrial policy flows from concern about unemployment. The unemployment problem facing America is partly attributable to the 1981-1982 recession and partly to the structural readjustments taking place in the economy. Some industrial policy advocates would provide federal subsidies to assist basic industries in return for industry assurances of programs to assist workers in retraining and in locating new jobs. Assistance would be provided to communities, business firms and workers that were hardest hit by adverse economic conditions.

One is reminded of the Appalachian Regional Development Commission (and subsequent regional commissions) and the Economic Development Administration. First created to provide assistance to economically depressed areas, political and economic pressures for eligibility assistance led to some 85 percent of the nation's counties being considered depressed for purposes of receiving assistance from the Economic Development Administration -- "The EDA Effect."

Plant closings for whatever reasons can be traumatic to displaced workers and indeed to an entire community. The U.S. Chamber supports federal assistance for displaced workers. There already is in place a comprehensive array of federal and state programs to aid displaced workers. There is the federal-state system of unemployment compensation. Free job search assistance is available for all applicants through the employer-funded U.S. Employment Service. Special assistance is provided for all dislocated workers under Title III of the 1982 Job Training Partnership Act, which is supported by the U.S. Chamber.

Special new programs for job creation are not needed. As the economic recovery continues, economic growth will be the most important force in providing job opportunities. Since last December, the expanding economy has added 2.9 million new workers to the employment rolls. It is vitally important that no new disincentives to mobility be established through subsidies to declining industries and areas.

MISALLOCATING FUNDS THROUGH A NATIONAL BANK

The above notwithstanding, some industrial policy advocates believe that it is necessary to identify "sunrise and sunset" industries, and to allocate capital accordingly. "Picking winners and losers" is a catchphrase with a simple appeal. The issue here is obviously more complicated, and there are many variants. Yet, channeling funds into growth industries -- as a result of a decision-making process involving eminent, intelligent, respected and compassionate members of government, business, labor, academia and others -- may mean less funding available for basic industries. This is justified by some because industrial policy should influence the flow of capital, labor and other resources toward America's emerging -- not its mature -- industrial base.

However, the list of future growth industries has been determined by the marketplace -- robotics, biotechnology, CAD/CAM manufacturing, communications, computers, microelectronics. The American capital market has been picking these winners, and rapidly growing high-technology firms have been attracting the private capital they need. They do not require federal subsidies. During the first four months of 1983, primary public offerings exceeded the total offerings for all of 1981, a record year for new offerings. And in the first eight months of 1983, the volume of public offerings was in excess of $73 billion, with new unseasoned issues setting records. Indeed, such offerings are up 463 percent from the same year-ago period. This was the result of lowering the capital gains rate in 1978 and 1981.

Notwithstanding these capital flows, some people demand that government create a national bank to facilitate the process of industrial development by providing sufficient funds at reasonable interest rates for projects that the bank's "members" deem worthy of supporting. In short, a national development bank will intervene in the credit allocation process.

In general, Congressional proposals under consideration would establish a national development bank, patterned after the Reconstruction Finance Corporation (RFC), the institution created during the Great Depression.

For those who remember the RFC, this peculiar act of necromancy is not a reassuring thought! The RFC provided for massive government intervention in the economy by extending loans and loan guarantees to borrowers who could not get money from others on "reasonable" terms. Contrary to popular belief, it was a dismal failure. Unemployment remained high until World War II. Meanwhile, Congressmen scrambled to ensure that their constituents received a "fair share" of the largesse.

One prominent advocate of a new RFC says that it would do one thing the market doesn't do -- make deals. This is precisely what should be avoided. Credit markets serve the role of evaluating the risk of alternative projects. Those with higher probability of failure are charged higher borrowing costs. An RFC, on the other hand, would socialize risk. And, once politics becomes a part of the credit allocation process, politically favored projects would rule the day. There are, after all, more than 150 federal loan guarantee programs which presently guide the allocation of over $200 billion in government loans and loan guarantees yearly. Every year, billions of dollars of private investments do not take place because of these federal loan guarantee programs.

And this, of course, is the crux of the matter. A resurrected RFC would create no new credit or savings. Rather, it would reallocate that which already exists. Thus, for every investment supported by a new RFC, dollars would have to be taken away from some other sector of the economy, be it housing, consumer lending or small business.

THE PROBLEM RESTATED

It is ironic that non-market capital allocative schemes are in vogue among many industrial policy advocates in the year Gerard Debreu is awarded the Nobel prize in economics. Debreu's great contribution has been to demonstrate mathematically that the invisible hand works, that, through the price mechanism, the most efficient allocation of resources is achieved.

Let me put it another way. What we are really talking about in the industrial policy debate is the age old question of what form of economic organization will best move the economy forward while meeting the needs of society.

It seems to me that both experience and theory support the position that the market system of organizing economic activity is by far the best.

To repudiate the price mechanism as an information system and guide to the most efficient allocation of resources in all sectors of the economy would be to repudiate a unique and irreplaceable social discovery. The principal reason the socialist economies are so inefficient in allocating resources is their rejection of the free-market price mechanism, making economic calculation a matter of government fiat, guess work or arbitrary proclamation or some combination of all three -- the substitution of centralized authority for decisions at the lowest level where there is competence to act.

Moreover, decisions to allocate capital and other resources to some industries and regions are simultaneously decisions to withhold productive resources from other industries and regions. Insofar as resources may be allocated to industries or regions that otherwise would decline, not only are resources misallocated, but also the process of readjustment, necessary to the ultimate economic health of the subsidized sectors, is delayed. This, of course, is a perverse policy outcome.

An additional consideration that should be of special interest to those who are concerned about innovation, productivity and economic growth is the effect on small business of these kinds of proposals. Small businesses would surely be at a disadvantage as industries, firms and regions strive to obtain funds from a National Development Bank. Larger units with larger numbers of constituents would have a built-in advantage in gaining attention and funds. Yet historically, some of the most important innovations have come from small firms. Non-market allocation of capital through a National Development Bank would place such innovative entrepreneurs at an even greater disadvantage in obtaining funds for research and development and for expansion.

In sum, industrial policy calls for substantially more government control over economic decision-making and the allocation of credit. It is being sold as an idea that can be all things to all people. Its proponents hope to win public support and then congressional approval. The Supply Side approach, in contrast, does not target industries, bail out losers or throw money at winners. Rather, the Supply Side approach is non-targeted, in the sense that there is no need "to direct, aim or guide the public resources released to the private sector in any particular way. Indeed, freeing them to go wherever the market will take them is the kernel of the approach."

The market allocation of resources through the free market system has been responsible for the greatest economic successes in history. Political or bureaucratic resource allocations have been responsible for some of the world's greatest failures. Armed with this information, do we really have a choice?

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