

# Industrial Change and Public Policy

by Marvin Duncan and Marla Borowski

The severity and duration of recent recessions have prompted a reevaluation of traditional U.S. economic policy and a search for alternatives to improve the nation's economic performance. One of the alternatives is an "industrial policy" that would identify important industries and assist them by providing subsidized credit, protection from foreign competition, and export subsidies.

The call for a targeted industrial policy is based on the assumption that structural change in the economy has substantially dislocated resources and created a loss of competitiveness in both domestic and international markets. It is also based on the assumption that government can correctly identify industries of future importance and devise policies to speed their growth, thus easing structural adjustment and strengthening market competitiveness.

To examine recent changes affecting the U.S. economy and the likely success of a government-managed industrial policy, the Federal Reserve Bank of Kansas City sponsored

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its sixth annual economic symposium at Jackson Hole, Wyoming, on August 24-26, 1983, to discuss the topic of "Industrial Change and Public Policy." This article summarizes the presentations and discussions of the distinguished group of participants at that symposium.<sup>1</sup>

## Poor performance of the U.S. economy

Lawrence Klein stressed that an understanding of change is essential to a proper appreciation of what is happening to the economy. Although the performance of the U.S. economy has been disappointing for two decades, he pointed out that structural change may not be the cause.

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<sup>1</sup> Participants at the symposium included Lawrence R. Klein, Benjamin Franklin professor of economics at the University of Pennsylvania and 1980 Nobel laureate in economics; Robert Lawrence, senior fellow at the Brookings Institution, Robert Hall, professor and Hoover Fellow with the Hoover Institution, Stanford University; James Tobin, professor of economics at Yale University and 1981 Nobel laureate in economics; Paul Krugman, associate professor of management and economics at the Massachusetts Institute of Technology, Michael Wachter, professor of economics at the University of Pennsylvania; William Wascher, research economist at the Board of Governors of the Federal Reserve

A combination of exogenous shocks and cyclical adjustments has been the driving force of recent economic history, he said. Inflation was boosted by deficit financing of the Vietnam War and increases in the prices of energy and food. With increasing oil prices, capital investment in industrial countries was concentrated on improving energy efficiency, and performance in the industrial countries slowed. Growing foreign exchange reserves of OPEC countries flowed through the world's commercial banking system to developing countries. When interest rates rose, the developing countries could not service their increased debt. In the industrial countries, restrictive policies aimed at combating inflation brought on recession and unemployment. Unemployment was also exacerbated by rapid growth of the labor force.

In the United States, Klein said, tax laws have been changed substantially. Both capital gains and regular rates have been lowered. While the lower capital gains rate has stimulated some venture capital expansion, the lower regular tax rate has caused lost revenue and large federal budget deficits. More liberal depreciation rules could increase businesses' accumulation of funds for capital expansion, but no expansion is underway yet. Finally, the deregulation of financial markets has substantially affected aggregate economic performance.

According to Klein, cyclical factors will continue to be the main determinant of economic performance. The Wharton Econometric forecast for industrial democracies in the 1980s is for about 1 percent slower growth, 3 percent higher unemployment, and 3 percent more inflation than in 1950-60 and 1960-70.

Robert Lawrence shared Klein's conviction that recent U.S. economic performance can be ascribed primarily to cyclical and exogenous factors. He went on to say that America is not deindustrializing. According to Lawrence, employment, capital formation, research and development expenditures, labor productivity, and growth in output of manufacturing in the United States over the last decade have been at least as good as in other industrial countries. Because manufacturing output is quite sensitive to GNP growth, the recent slowing in the sector should be attributed to sluggish economic growth, not to underlying structural change.

Lawrence said that shifts in consumer preferences have reduced the share of manufactured goods in consumer spending. Similarly, productivity growth has reduced manufacturing's share of total employment. The sector's share of fixed business capital investment has increased. Furthermore, growth of the capital-labor ratio in manufacturing has also increased. The nation's performance also benefits from more flexibility in real wage growth and greater labor mobility than in many other industrialized countries.

Internationally, he said, the pattern of comparative advantage has shifted somewhat because of foreign economic growth and policies. The United States is increasingly more competitive in high technology production than in traditional capital-intensive and labor-intensive production. In fact, the United States generally maintains an overall advantage in

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System; Barry Bosworth, senior fellow at the Brookings Institution; Edwin Mansfield, professor of economics at the University of Pennsylvania; J. David Richardson, professor of economics at the University of Wisconsin; C. Fred Bergsten, director of the Institute for International Economics, William Diebold, Jr., senior research fellow at the Council on Foreign Relations; George Lodge, professor of business administration at the Harvard Business School; and Jerry Jasinowski, senior vice president and chief economist of the National Association of Manufacturers.

manufacturing. Favorable exchange rates boosted U.S. production and employment in 1973-80. But recent appreciation of the dollar in foreign exchange markets has reduced manufacturing's benefits from trade, a condition likely to continue through 1984.

Neither Klein nor Lawrence accepted the assumption that the structure of the U.S. economy has changed. Rather, they both asserted that recent performance results from sharp cyclical swings in the economy. Both conceded that such marked cyclical swings could result eventually in lasting changes in U.S. industry. They implicitly argued, therefore, that policies to deal with cyclical fluctuations are more likely than industrial policies to improve the economy's performance, both in the short run and over time. That prescription was a recurring theme as other participants examined policy options and implications.

### **Macroeconomic policy prescriptions**

Structural changes should be kept in mind in developing U.S. macroeconomic policy, Robert Hall said. Although the differences between structural and other changes are not sharply defined, he pointed out that prudent policy should be based on consideration of all changes that significantly affect performance. Further, policy goals should probably not be discussed in terms of highly specific targets for output, unemployment, inflation, or interest rates because they are too strongly affected by underlying change. Very specific goals can be unrealistic or contradictory.

Targeting the growth of nominal GNP is Hall's choice for the most satisfactory monetary policy rule. Congress, according to Hall, could adopt a target path for nominal GNP, thus setting a strict, quantitative rule for the Federal Reserve to follow. When nominal

GNP was above (below) the target path, monetary policy would contract (expand) the rate of growth of the money supply as needed to return to the path. While this rule would not guarantee perfectly stable prices, it would prevent a serious inflationary spiral. And while it would not prevent recessions, it would lessen their intensity.

As an alternative to the currently flawed U.S. fiscal policy, Hall proposed a 19 percent flat-rate consumption tax. He saw its advantages as providing the revenues for running the government, eliminating the tax preferences that now distort capital investment decisions, and encouraging investment over consumption. Such a tax would meet these objectives over time, he said, despite economic change.

Hall also proposed reform for Social Security. He suggested that the system be divided into two parts, one an actuarially fair disability and retirement system financed by mandatory contributions, the other an income redistribution system financed by the flat-rate consumption tax. But Hall, in his proposal, specifically rejects reductions in Social Security benefits.

Responding to Hall's presentation, James Tobin noted that diagnoses of the economy typically fall into two classes, the macro and the micro. He characterized the macro diagnosis as viewing the central problem as a reconciliation of full employment of labor and capital with price stability. This problem can best be solved through appropriate macroeconomic policies. He saw the micro diagnosis, on the other hand, as viewing structural change as the main problem and industrial policy as the solution.

According to Tobin, industrial policy advocates believe that the United States is losing its competitiveness in world markets and that

the risk of new technologies and investments is too great for the private sector to bear. He felt these beliefs are incorrect. He said the worldwide recession and the high-valued dollar have hampered U.S. performance in international markets. Furthermore, he thought that concern over private sector risk-bearing was misplaced. Large U.S. financial markets, he maintained, offer adequate support for funding socially viable projects.

Tobin's solution for the nation's economic problems was a change in macroeconomic policy. He believed that over a five-year period, Congress, the President, and the Federal Reserve should agree on real and nominal economic targets and aim openly at announced growth paths. The paths should be reconsidered annually. A nominal GNP target, although fixed for a year, would be consistent with the five-year goal. He also proposed an incomes policy — wage and price guideposts with tax-based inducements for compliance — as an adjunct to the targeting of macroeconomic variables.

### **Alternative policy prescriptions**

In addition to agreeing on the need for macroeconomic policy changes, participants identified several sector-specific policy prescriptions for improving U.S. economic performance. These included targeted industrial policy, as well as labor, capital investment, technology, and trade policies.

#### ***Targeted industrial policy***

Despite the likely effectiveness of better macroeconomic policies in improving the nation's economic performance, some observers today are intrigued with the prospect of a targeted industrial policy that would shape and

support industrial development. The case for a targeted industrial policy, according to Paul Krugman, stands or falls on the issue of criteria for selecting industries to be targeted. Suggestions for selection criteria come from two sources — popular discussion and economic theory.

The criteria most often advocated in popular discussions include the amount of value added per worker, the magnitude of linkages to the rest of the economy, the prospects for future international competitiveness, and targeting undertaken by foreign governments. Krugman found that applying the first criterion would likely result in slower growth and higher unemployment. The last would direct investment into industries with excess capacity and depressed rates of return. While the other criteria are less obviously counterproductive, he said, they are not unequivocally beneficial.

Economic theory suggests that industrial policies could succeed. Economies of scale, imperfect competition, external economies, and government programs are market imperfections that industrial policy could address. But Krugman noted that economic theory provides no unambiguous criteria for formulating targeted industrial policy.

Krugman pointed out that after-the-fact evaluation of the effectiveness of industrial policy is difficult. He suggested that the Japanese targeting of steel may have actually lowered Japan's national income and that this targeting was not crucial to current American-Japanese competition. Finally, he said, industrial policy could be simply ineffective.

#### ***Capital investment and technology***

Discussion of tax incentives to encourage private savings and thus increase capital

investment is misguided, Barry Bosworth said. Demand for investment is down, according to him, not because businesses lack funds to invest, but because financial and monetary policies have led to high interest rates and an appreciated dollar. Enough idle resources exist to support increased investment in the short term. Over the longer term, the government should reduce the federal budget deficit and increase public pension programs to expand the pool of available capital.

Bosworth asserted that the capital tax structure should receive more attention in policy-making. Discussion has centered erroneously, he said, on average and marginal tax rates. The pattern of tax preferences for one type of capital goods over another has resulted in distortion, waste, and misallocation of investment funds. Either a consumption-wage tax or a comprehensive income tax could address the issue of preference.

The high rates of return on spending for research and development justify more government involvement. He proposed, however, that increased public support for basic research should take the form of direct government expenditures, instead of tax incentives for private investment.

Market economies often underinvest in civilian technology because firms do not benefit enough from their own research efforts, Edwin Mansfield explained in his comments on Bosworth's views. But because of the high average and marginal social rates of return from industrial R&D (often 30 percent or more), governments encourage it. American firms have recently received tax credits for increased spending on research and development. But evidence from the United States, Canada, and Sweden indicates that tax incentives have little effect on R&D spending. In the American case, the increase in spending is

considerably less than the revenue lost to the Treasury.

Government spending is most effective, Mansfield says, when it goes for long-term basic R&D, which has a disproportionately large effect on productivity. An industry's rate of productivity increase and a firm's rate of innovation are positively related to spending on long-term and basic R&D. Mansfield shared Bosworth's conviction that direct government support for long-term basic R&D should be preferred over tax incentives for research.

### *Labor policies*

The basic problem facing today's displaced workers, Michael Wachter and William Wascher contended, is not a lack of jobs, but the difference between their opportunity wages and the wages they were paid on the last job. Because some workers were able to limit, or even avoid, the decline in average real wages over the 1970s, there were wide differences in interindustry wage changes. High-wage/low-wage or union/nonunion industry wage differences increased persistently. These wage differentials affected workers two ways, they said. The greater their wage premium over their opportunity wage, the greater the income loss to displaced workers. And the greater the union wage premium, the greater the likelihood that workers will be displaced.

The environment for labor improves as the economy expands again. Manufacturing employment is increasing, even in industries with long-run declines. And wage differentials, which peak during a recession, are declining. Also, the outlook is more optimistic over the long term. The economy's ability to employ available workers during a recession will improve as technology changes. More-

over, growth of the labor force is moderating. And the problem of mismatches between unskilled workers and high-skill jobs may be reduced in the future.

Government policies that minimize losses to displaced workers have been generally procyclical, Wachter and Wascher contended. They found the solution to the displaced worker problem in the private sector. The surest way to prevent the problem is to avoid the loss of jobs in the first place, and the private sector is responsible for most jobs. Thus, they expected that new collective bargaining initiatives, particularly tradeoffs for job security, will probably receive increased attention from both employers and employees.

In commenting on the paper by Wachter and Wascher, Ray Marshall argued that the structural unemployment problem is larger and more serious than merely the problem of displaced workers. The problem of disadvantaged workers is at least as serious, and it is growing. Government can ease labor difficulties through adjustment policies that go beyond mere income maintenance programs for displaced workers. Community-based programs addressing specific problems and administered by labor, management, and community representatives can be successful, he said, citing the Downriver Program in Wayne County, Michigan.

He thought other selective labor policies — relocation and retraining programs, for example — need to be directed at disadvantaged workers, such as the young, minorities, and the uneducated. Unemployment problems are likely to get worse for these groups over the coming decade. Though macroeconomic policy is ultimately responsible for moderating cyclical instability, and hence unemployment, complementary labor policies can increase the effectiveness of macroeconomic policy.

### *Trade policies*

J. David Richardson assessed the potential of trade policies for improving economic performance. The international economic and political environment, he said, has changed significantly over the past several years. As a result of economic growth overseas, the disparity between the U.S. economy and the economies of its industrial trading partners has been greatly narrowed since the end of World War II. International trade has increased dramatically, with changes in both the types of goods traded and the patterns of trade. Growth in net exports of manufactured goods has slowed in the United States in recent years. Conversely, foreign countries have become more vigorous competitors in our domestic markets. On balance, global trade has become more disorderly as governments more frequently help domestic industries improve their competitive positions.

In this disorderly environment, Richardson envisioned a place for a more active U.S. trade policy, arguing that strategic trade policy could help counter the distortions of an imperfectly competitive world system. If the United States could limit foreign government market intervention by using an active policy that is predictable, nondiscretionary, and contingent on certain behavior, he said, the world market might become more competitive. That, in turn, would be more likely to provide U.S. gains from trade. Where oligopoly distorts the market, an active U.S. trade policy might capture a larger national share of profits.

Other sources of imperfection, such as scale economies and lack of information might be corrected through strategic policies, such as a return to “rules” in trade and bilateral agreements. Such policies, Richardson said, could

provide a safety net for some sectors of the population and could help ease adjustment to new economic conditions. Trade policy can also cushion the effect of economic and political shocks on domestic industries, whether the shocks are from domestic or international sources.

As a response to change, however, an active trade policy has several shortcomings, Richardson said. It is difficult to manage, it gives the appearance of aggressiveness, and its costs can be high. Richardson suggested that other approaches might be better. Among these he included better macroeconomic policymaking, stabilization of exchange rates, programs to ease shifts in labor and capital use, and greater reliance on market forces.

Fred Bergsten emphasized the high value of the dollar in responding to Richardson's paper. The dollar, he thought, is greatly overvalued compared with the underlying competitive relationship between the United States and its trading partners.

He cited the misalignment of the dollar for the stunning loss of American competitiveness in international trade. The effect, he said, is pervasive across U.S. industries and appears to be growing more serious. Ironically, the problem is largely one of our own making and not one imposed by unfair trade practices or a major competitor.

Returning to a recurring theme of the conference, Bergsten pointed to the huge federal budget deficit as the major source of the problem. Without prompt budget action, he said, sterilized intervention in exchange markets will be needed, along with greater policy coordination with trading partners. Over the longer run, the international monetary system could be made less prone to misalignments, perhaps by imposing "crawling target zones" for the currencies of major countries.

## **An overview**

Adding perspective to the symposium, three prominent observers of the U.S. economy contributed their views to the debate on policies dealing with industrial change. American economic policy, George Lodge argued, needs to recognize that three cherished myths about economic behavior do not correspond with reality. The first myth, that the static notion of comparative advantage determines the goods a country produces and that free trade follows, thereby allowing all countries to grow and prosper, has been disproved — first by the Japanese and then by other trading partners. Government policies can create and alter comparative advantage. When this happens, competitiveness and the premise of free trade can be fundamentally disrupted.

In such an environment, the United States has two choices. It can devise a coherent national strategy itself, or it can continue its haphazard reaction to the policies of others.

Either solution destroys the second myth. The American belief that government should be limited, decentralized, and not include coherent planning is ill-suited to current world conditions. Government policies around the world have a great effect on economic performance. On the positive side, however, greater understanding of the effects of government programs — which are sometimes contradictory and generally unplanned — is forcing the U.S. government to take on a more coherent and active role.

The third myth, that the relationship between manager and managed is typically adversarial, is being eroded by increasingly wider public ownership of firms. Both groups now realize that their shared interests far exceed their conflicts. As a result of the changing relationships among shareholders,

debtholders, managers, managed, and government, new concepts of corporate governance are required to assure future American competitiveness.

William Diebold noted his agreement with views often expressed at the symposium — that the case for structural change may not be compelling and that it would be difficult to implement planned industrial policy in the United States. Planned industrial policy aside, however, he said that some areas deserve further analysis. Better understanding of particular industries and specific sectors, the operation of markets, the effect of externalities, and the impact of government is vital for effective, equitable policymaking.

Diebold stressed again the importance of the international ingredient in American economic activity. American competitiveness, foreign government intervention in markets, and international cooperation all have implications for the U.S. domestic economy that need to be better understood.

Contending that U.S. industry may have deteriorated, Jerry Jasinowski thought there could have been four causes. Cyclical instability, he said, has resulted primarily from faulty demand management policies and the OPEC oil price increases. Lack of competitiveness in international markets and long-term structural difficulties each have contributed to poor U.S. economic performance. And finally, factors at the industry and sector level have had an effect.

Public policy can address the first three causes, but microeconomic factors remain the responsibility of the private sector. Eliminating the structural federal budget deficit and adopting multiple targets by the Federal Reserve would help stabilize the economy. Other national strategies for reversing industrial decline include promoting exports to

improve competitiveness, speeding capital recovery, removing energy price controls, and providing tax incentives to spur private sector research and development.

## Conclusions

Despite much popular rhetoric, the predominant view of symposium participants was that America is not deindustrializing. Neither are its economic problems due primarily to sweeping structural change in the economy. Rather, most of its problems are the result of sharp cyclical fluctuations that could have structural implications over time.

More appropriate and better coordinated monetary and fiscal policies, it was felt, offer a solution to the inadequate U.S. economic performance. Additionally, a range of improved policy options were suggested at the sector and firm level. These included actions to improve labor competitiveness and mobility, changes in tax policies affecting capital investment, increased government funding of basic and long-term R&D, more rational U.S. trade policy, and greater international coordination on exchange rate and trade policy issues.

Symposium participants generally shared a common viewpoint — that the recent inadequate U.S. economic performance has not been caused by structural or industrial change. Rather, it has been a combination of inappropriate macroeconomic policies, a prolonged cyclical downturn, and exogenous shocks. Therefore, changing policies at both the macro and sub-macro levels to mitigate their undesirable effects was believed to be a more promising alternative than identifying and implementing an entirely new “industrial policy.”

# Industrial Change and Public Policy

Industrial policy proposals have recently been put forward as a means to help deal with the disappointing performance of the U.S. economy over the past decade. To examine the rationale and value of these proposals, the Federal Reserve Bank of Kansas City brought together a number of leading economists for a symposium on industrial change and public policy at Jackson Hole, Wyoming, on August 24-26, 1983. Contents of the 378-page proceedings are listed below.

Moderator: *George L. Perry*

Moderator: *Robert C. Holland*

Identifying the Effects of Structural Change,  
*Lawrence R. Klein*  
Commentary, *Jeffrey Sachs*

Labor Market Policies in Response to Structural  
Changes in Labor Demand, *Michael L. Wachter*,  
*William L. Wascher*  
Commentary, *Ray Marshall*

Changes in U.S. Industrial Structure: The Role of  
Global Forces, Secular Trends, and Transitory  
Cycles, *Robert Z. Lawrence*  
Commentary, *Lawrence Summers*

Capital Formation, Technology, and Economic Policy,  
*Barry P. Bosworth*  
Commentary, *Edwin Mansfield*

Macroeconomic Policy Under Structural Change,  
*Robert E. Hall*  
Commentary, *James Tobin*

International Trade Policies in a World of Industrial  
Change, *J. David Richardson*  
Commentary, *C. Fred Bergsten*

Targeted Industrial Policies: Theory and Evidence,  
*Paul R. Krugman*  
Commentary, *George C. Eads*  
Commentary, *Robert Kuttner*

Overview Panel, *William Diebold*, *George C. Lodge*,  
and *Jerry Jasinowski*

For a free copy of the proceedings of this symposium, or any of the previous symposiums listed below, write the Public Affairs Department, Federal Reserve Bank of Kansas City, 925 Grand Avenue, Kansas City, Missouri 64198.

*Monetary Policy Issues in the 1980s* (1982)

*Modeling Agriculture  
for Policy Analysis in the 1980s* (1981)

*Future Sources of Loanable  
Funds for Agricultural Banks* (1980)

*Western Water Resources. Coming Problems  
and the Policy Alternatives* (1979)

*World Agricultural Trade:  
The Potential for Growth* (1978)