PICKING LOSERS, KILLING WINNERS

By Michael J. Boskin

One of the worst responses to the financial crisis and deep recession has been the revival of "industrial policy", the usually ill-advised attempt by governments to promote particular industries, companies and technologies at the expense of broad, even-handed competition. Industrial policy has surged in advanced economies which long resisted its worst excesses (the U.S. and U.K.), emerging economies (Brazil and China), and traditional practitioners (France).

Like the mythical monster Hydra, who grew two heads every time Hercules cut one off, President Obama in his State of the Union and just-released Budget defiantly doubled down, despite the failures, farce and scandal in his programs, e.g. Solyndra, Ener1, Beacon Power and Fisker. Mr. Obama's brew of spending, regulation, mandates, special waivers, fines, loans and guarantees, subsidies and tax breaks is, quite deliberately, the biggest outbreak of American industrial policy since President Carter's proposed $88 billion ($240 billion in 2012 dollars) synthetic fuels program. Mr. Carter was trounced for re-election by free marketer Ronald Reagan.

Favoring key constituencies with taxpayer money appeals to politicians, who can claim to be helping the overall economy, but it usually does far more harm than good, is often backward looking, rarely prescient. It crowds out valuable competing investment efforts financed by private investors risking their own capital, and warps decisions by bureaucratic diktats susceptible to political cronyism. Former Obama advisor Larry Summers echoed most economists' view when he told the Administration, "The government is a crappy venture capitalist".

Markets function well when the returns are received and the risks borne by private owners. Governments should obviously fund defense R&D. Private firms cannot fully appropriate the returns to *pre-competitive, generic* R&D, e.g. for basic science and technology, from nanoscience to batteries, because it is readily available to all. So government should fund it when it passes rigorous cost-benefit tests and maintain a level playing field among alternative commercial applications.

For example, the computer-linking technology that created the Internet was funded by the Defense Department for defense purposes but, like numerous Defense technologies, wound up with commercially valuable civilian applications. But it would be foolish for the government to subsidize a particular search engine or social-networking platform.

The previous peak for industrial policy was in the 1970s and 1980s., when many Democrats demanded the government emulate Japan, then growing rapidly, by managing trade and directing specific technology and investment outcomes. Japanese subsidies mostly went to old industries like agriculture, mining, and heavy manufacturing. The government even tried to prevent Japanese car companies from exporting and Honda from expanding to cars from motorcycles! This extensive micromanagement was one reason for Japan's decades-long stagnation.

Industrial policy fever waned after the 1980s but never died. President George W. Bush, for example, expanded ethanol mandates and pushed hydrogen cars. Hydrogen's use for transportation must still overcome its flammability and combustibility, or we'll be driving mini-Hindenburgs. Even the EPA's 97% reduced cellulosic quotas couldn't be met; the National Research Council says there are *no* commercially viable biorefineries to convert it to fuel.

Even under optimistic projections, heavily subsidized wind and solar would each amount to a tiny fraction of global energy by 2030 and thus cannot be the <u>main</u> answer to any energy security or environmental problem. The short-run focus of most DOE funding misses the main strategic imperatives: we need alternatives that can scale to significance long-term without subsidies, and a lot more North American oil and gas (in part to replace field declines) in the meantime.

President Obama is spending immense sums for subsidies to particular industries and technologies, almost $40 billion for clean-energy programs alone (some, appropriately, for pre-competitive generic technology.) Yet a large number of venture-capital funds (many near Stanford) are devoted to alternative energy. They should be competing with each other and with the technologies they seek to replace, not for government handouts. Obama is giving the far more limited appropriate role of government-funded technology research a bad name by barreling through the precompetitive generic stop sign.

Meanwhile, the President blocks shovel-ready private investment, e.g. the Keystone pipeline, that would create thousands of American jobs, increase energy security, and even improve the environment. (The alternative is shipping the Canadian oil to China; we can refine it more cleanly than the Chinese; and pipelines are safer than shipping.)

Firms make mistakes and markets are not perfect, but it's a deeply dangerous conceit for anyone to conclude they can pick technology, firm, and industry winners and losers more successfully than the market. And a possible market failure won't necessarily be improved by government intervention. We must compare the imperfect government policies likely to be implemented with imperfect market outcomes; will they improve the situation AND merit the cost? Government failure, including crony capitalism, rent-seeking and dispensing, pork, and regulatory capture, is as pervasive as market failure due to monopoly, externalities, or information problems.

America certainly has energy security and potential environmental needs to diversify sources by type and by geography. The shale gas hydraulic fracturing revolution –credit due to Halliburton and Mitchell Energy; the government's role was minor -- is rapidly providing a piece of the intermediate-term solution.

Government should set sensible goals and enact even-handed policies to achieve them, then let entrepreneurs, investors, and consumers decide how best to do so. It should fund applicable, pre-competitive generic scientific and technological research, eliminate specific subsidies and lower tax rates for all with the proceeds.

The arguments mustered to promote industrial policy – infant industries; benefits of clustering and learning; and jobs, do not stand up to serious research and historical evidence. Echoing 1980s Japan-fear and envy, some claim we must enact industrial policies because other countries, e.g. China, do. Presidents Johnson and Nixon wanted the U.S. to build a supersonic transport (SST) plane because the British and French were doing so. The troubled Concorde was shut down after a brief run of subsidized travel for wealthy tourists and Wall Street types.

Our response instead should be 1) remove our own major competitive obstacles, e.g. more competitive corporate tax rates; more sensible regulation, improved K-12 education, and better job training for commercially demanded skills; (Mr. Obama’s green jobs training program – added on top of four dozen federal training programs -- spent hundreds of millions; 3% of enrollees had the targeted jobs six months later). 2) Base policies on sound economics. If another country has a comparative cost advantage, we gain from exchanging such products for those we produce relatively more efficiently. If we tried to produce everything in America, our standard of living would plummet. 3) Pursue rapid redress for illegal subsidization and protectionism in appropriate venues, e.g. the WTO, and strengthen those processes.

Fortunately, there is some promising news. Ethanol subsidies and tariffs (but not the increasing use mandate) expired in the New Year and there is a growing consensus to kill California's high-speed rail boondoggle. The state-appointed High Speed Rail Authority recommended against the program, as cost projections tripled to almost $100 billion, ridership projections plummeted and potential startup delayed a decade or more. Yet Mr. Obama offers subsidies to induce Governor Brown to add funds the state doesn’t have for a first stage between Fresno and Bakersfield that Californians don’t want enough to pay for.

So pervasive is this new government intervention in so many sectors that a vast array of unsubsidized firms are competing for capital and customers with government-subsidized firms forced to make non-commercial decisions. The end result cannot be good; witness the damage wrought by Fannie and Freddie.

Industrial policy failed miserably in the 1970's and 1980's. Letting governments rather than marketplace competition pick specific winners and losers is just as bad an idea today.

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