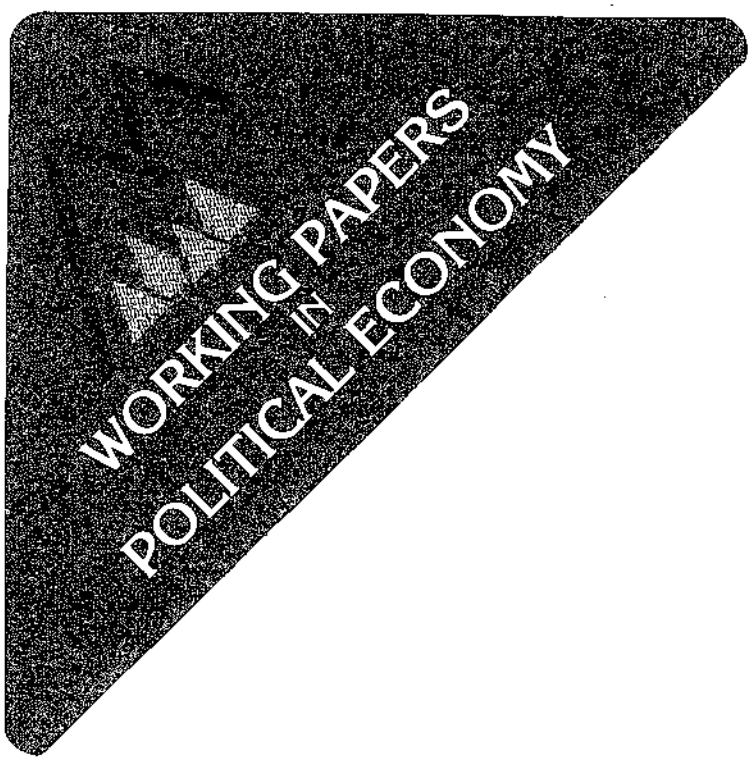

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THE JUNGLE BEHIND INDUSTRIAL POLICY

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Anthropologists and their subjects provide opportunities for more than the satisfaction of intellectual curiosity. Ethnographic studies may be relevant to important contemporary policy issues. For example, it is possible to view Melanesia's Cargo Cults as relevant analogies to industrial policies.

In the vast openness of the Pacific Ocean lies a group of islands inhabited by tribes known collectively as Melanesians. For thousands of years, these tribes existed in a primitive state, depending primarily on domestic pigs, gardens, and copra (a tropical fruit) as staples and producing no important commercial product. Nevertheless, during the early 1900s, the German government settled there and attempted to build copra and rubber industries on the larger islands. Predictably, using central planning to build such an industrial base was unsuccessful. Among other problems, rubbber and copra market prices were insufficient to cover shipping expenses. While the Europeans were unable to develop viable commercial activities, they caused a series of increasingly costly movements among the natives. Anthropologists have labeled these movements "Cargo Cults".

The Melanesian tribes depended on pig herds, garden produce, and wild fruits and tubers as dietary staples. In misguided efforts to increase pig and soil fertility, control the weather, and influence other factors contributing to their wealth, members of these tribes developed some bizarre and highly complex rituals. They believed, for example, that a concoction of male semen and female secretions would increase the fertility of everything from men to soil. "No soil would produce good foodstuffs unless the husband and wife first copulated in the new garden, made a brew of their collected juices and certain leaves, and buried portions of the mixture in various parts of the garden," writes K.O.L. Burridge in Oceania.

In this setting, the arrival of the Europeans created understandable shock among the residents of these primitive communities. For a people who used dogs' teeth, porpoise's teeth, and pigs' tusks as status symbols, we can perhaps understand the impressions the Europeans made when they arrived in ships and later airplanes with a seemingly endless supply of goods. The Melanesians reasoned that magic was the only force powerful enough to generate such wealth, and assumed that the Europeans had discovered some wonderfully potent rituals. Surely, such wealth must be from the gods themselves! If the natives were to acquire cargo for themselves, they had to discover and copy the appropriate rituals. The natives proceeded to invent a variety of "cargo" rituals.

These Melanesian tribes believed that if they were able to imitate European "rituals", the gods would bless them with cargo just as the Europeans had been so blessed. They confused ends with process; and in mimicking European forms, they wasted substantial portions of their scarce resources in pursuit of wealth. Consider the following "rituals":

* During World War II, one tribe spent weeks preparing and building an "airport", because it had observed U.S. soldiers "attracting" cargo planes with landing strips and control towers. The natives hacked an airstrip out of the jungle and built a bamboo flight tower, complete with wooden microphones, instrument panels made from bamboo, and earphones made of bark.

* Some tribesmen noticed that the Europeans kept vases and bowls of flowers on tables and windowsills, so they proceeded to decorate their own houses and in some cases entire villages with freshly picked flowers to entice the flow of wealth in their direction.

* American troops stationed on the islands during World War II watched in wonder as natives, dressed in khaki pants and armed with wooden rifles,

marched in formation with "U.S." painted on their bare backs.

Other cargo rituals were less amusing. The natives' search for wealth often reached destructive and wasteful proportions as the tribes adopted new customs and sacrificed precious possessions. In attempting to please the cargo gods and demonstrate their faith, they destroyed crops, slaughtered pigs, burned houses, and threw valuables into the ocean. This kind of behavior peaked when the tribal society suffered shock or trauma. In New Guinea, for example, traditional ceremonies were twice replaced with cargo cults when diseases brought to the islands by the Europeans raged through the villages. Droughts, earthquakes, and tropical storms precipitated similar activities.

When a society is confronted with the spectacle of incomprehensible and unattainable wealth, when that society fails to understand how wealth is created, and when that society is experiencing trauma, we are not surprised that they look for desperate, quick-fix measures.

Tropical Hurricanes and Double-Digit Inflation

With a spin of the globe, the islands disappear, the expanse of the blue Pacific appears briefly, and North America appears. Both culturally and geographically, the comparison is extreme. But parallels can be found in the way both societies react to new events.

Since the Constitution's inception, the U.S. economy had grown at a rate of roughly 2.4 percent until the 1970s. From that time until quite recently, productivity dropped to one-half of one percent. This stunted growth involved with double-digit inflation, increasing bankruptcy filings and interest rates, growing deficits, record joblessness, and shrinking old-line manufacturing production. These factors affected Americans much as natural catastrophies

affected the Melanesians. After being exposed to European wealth and especially during or after a period of extreme calamity, the natives confused ends with process and squandered much of what they had in efforts to secure wealth from the cargo gods. To us it is obvious that such efforts are fruitless, but a sobering parallel can be drawn.

We have watched Japan and several European countries steadily outperform our economy, which is just pulling out of a performance slump labeled by some as the Great Recession of 1981-83. Furthermore, as the 1984 elections approach, nearly every Democratic candidate constructed political platforms containing a major plank supporting some form of industrial policy. These candidates have called for tougher laws restricting plant closings, for expanding protection against foreign imports, and for increasing governmental spending on unemployment compensation and worker retraining, and most seriously, for the allocation of capital. Bills presently before Congress spell out plans to create something similar to the Reconstruction Finance Corporation which was designed to allocate low-interest loans and subsidies for both sunrise ("promising") and ailing industry, while providing workers with federal subsidies to purchase their closed plants.

Though the specific proposals are numerous and "the idea is politically attractive, partially because it remains so ill-defined," says Richard KcKenzie of Clemson University, the underlying objective of industrial policies is to accelerate the progress of sunrise industries, to save ailing industries, and to promote the welfare of workers who become misplaced, replaced, or sidelined because of the changes that occur in our economy.

Lack of consistency and internal contradictions permeate the industrial policy proposals. The problems and misconceptions inherent in cargo cult activity drive much deeper than the cults' inconsistency and lack of definition. If the natives from the various islands were to hold a cargo

convention and agree on cult procedures, establish standards, and spell out objectives, they might agree to adopt the "airstrip" ritual as the optimal strategy for attracting wealth. As a result, airstrips might be constructed on all of the islands according to uniform standards. Despite uniformity, Weberian efficiency, and cooperation, the consequences remain predictable. First, potentially productive resources; i.e., gardens and livestock, would be neglected as human and physical capital are diverted from productive activities. Second, no planes, unless in need of an emergency landing, would land on the makeshift airstrips. Third, some local leaders would gain in the process.

Industrial Policy proponents' hopes of stimulating the economy through an industrial policy—i.e., by creating wealth through governmental planning and allocation—suffer from a similar "Melanesian misconception." There is a belief that centralized planning and capital allocation, along with controlled economic stimulation, yield results superior to those produced by a spontaneous order of individuals operating with clearly defined, enforced, and transferable property rights. When government is responsible for distributing capital, decisions are determined by concentrated special interests, appointed experts, and bureaucrats who are buffered from the long-run effects of their actions. Under such conditions, industry's attention is diverted from the market, where enhanced efficiency determines survival, to the political arena as resources are increasingly diverted in attempt to influence government. Thus, actions in our modernized culture also appear to have confused ends with process and we risk losing substantial quantities of resources through the proposed industrial policies.

European Magic and Japan's MITI

Just as the natives observed and imitated the Europeans, U.S. businessmen, labor leaders, and policy makers study Japanese actions in search of clues that can help explain the phenomenal economic growth of "Japan Inc."—that magically efficient Japanese productivity machine. As foreign-made automobiles, televisions, stereos, and high-tech imports have claimed large shares of our domestic markets due to their lower prices and higher quality, industrial policy advocates claim to have discovered Japan's key to success: MITI—the Ministry of International Trade and Industry. As the National Journal reports, the perception is that "the Japanese government, working closely with the private sector, sets a specific goal for a particular industry and then initiates a series of government and private sector actions designed to help achieve it."

Katsuro Sekoh, director of International Economics at the Council for Competitive Economy, feels otherwise:

> ...many observers of Japan have committed the classic fallacy of elementary logic—cum hoc ergo proptor hoc (false association). Since Japan has something those observers choose to call an industrial policy and since the country's industrial capacity has been growing dramatically, they conclude that there must be a causal relationship between the two. Yet other concurrent factors just as easily could be selected to explain Japan's successes. There is, for example, Japan's generous tax treatment of investment income—similar to supply-side economics. There is Japan's determination to improve quality control. And there is, of course, the 'uncorking' of Japanese entrepreneurship due to the explosion of political and social freedom after 1945. Strangely, these factors are ignored by advocates of an American industrial policy.

Efforts to enlighten advocates are most often met with stiff resistance. When the Europeans realized the impact they were having on the Melanesian culture, they tried to discourage the belief that wealth was brought by "cargo gods." The Europeans, frustrated with trying to stifle the cults, finally arranged for several tribal chieftains to visit Europe to see that wealth was not created by magic or ritual. When the chieftains arrived, they were taken

through factories, plants, and warehouses so that they might grasp the entire process by which goods were produced. The Melanesian leaders understood how the resources were used, what the assembly lines produced, and how these inputs were converted into final products. Assured that the visit had convinced the chiefs to put a stop to the cargo cults, the Europeans flew the chieftains back to the islands.

Upon returning to islands, the chieftains told tribal members that the Europeans' cargo in the foreign country was far greater than it was on the islands but that the Europeans produced the cargo in factories from raw materials. The raw materials had been delivered by the gods, the chieftains pronounced, so it was imperative that the natives be more dedicated to cargo ritual. A flurry of new magic and ritual ensued.

Industrial advocates suffer from a similar short-sightedness. Even though the evidence clearly shows that MITI is not responsible for Japan's extraordinary success, the proponents of Industrial Policy push for tighter MITI-like governmental planning in the U.S. If there is a cause and effect relationship between MITI and economic growth, however, it should not be difficult to uncover by comparing the success of MITI-backed industries to those that have been left relatively untouched.

In a report compiled for the Heritage Foundation, several relevant questions about Japanese industrial policy were examined:

1. Do governmental expenditures dominate the economy?
2. Is governmental aid a major contributing factor to the phenomenal growth of Japan's most successful industries?
3. How successful have the targeted industries been?

resources a government allocates is inversely related to the economic success of that country. By the late 1970s, government funded research and

development in Japan was lower than it was in both West Germany and the U.S. Government-funded research and development is: 50 percent in the United States, 40 percent in West Germany, and 30 percent in Japan, where only 5 percent flows into private industrial research. This indicates the rather limited influence of Japan's governmental investment program.

When one conjures up images of Japanese industrial strength, computers, automobiles, and electronic products come to mind. Should MITI be credited with this success as industrial policy proponents insist it must? When Japanese industries that are experiencing substantial growth are examined, it is evident that there is an inverse relationship between MITI's involvement with any specific industry and the growth of that industry. The machine and information industries in that country receive a meager 0.8 percent of its Fiscal Investment and Loan Program's (FILP) total annual investment from special loans. Technological development as a whole received considerably less than what was loaned to ocean shipping, urban development, or energy resource sectors, according to the Heritage study. Technological development places second to dead last on FILP's priority budget list, perhaps helping explain its phenomenal growth.

Third, it is useful to examine those industries with which MITI has been most involved. Areas targeted for heavy financial assistance include agriculture, coal mining, ship building,-petroleum refining, and petrochemicals. Agriculture is by far the most inefficient of Japan's significant industries. The coal mining industry, despite large influxes of government capital, has steadily declined since 1972, and production has fallen off to less than half of its 1962 level. Until the oil shock in 1S73, when the Japanese shipping industry was decimated, shipbuilding had been cushioned with subsidies. Since then, 19 companies have closed, 45,000

workers have been laid off, and output has fallen by 65 percent.

The Japanese aluminum industry has also suffered. Governmental direction first created excess capacity, which led to a structurally depressed industry. Soon, however, Japanese aluminum producers will suffer no longer as this heavily supported industry may go out of business, leaving Japan to import all of its aluminum, a rational decision given market conditions.

It seems that Japanese "industrial policy" has contributed as much to their economic success as magic, ritual, or cargo gods did to the Europeans' wealth. In the early 1970s, MITI attempted to conglomerate the Japanese auto firms into one corporation. Only by the refusal of these auto producers to join together have they become independent, internationally competitive firms. Perhaps a more apporiate observation is that Japan has experienced economic success _despite_ MITI's actions. Blather than "magic or MITI," credit must be given where it is deserved: to European and Japanese entrepreneurship.

The Asian Crescent and U.S. Entrenchment

Because of this entrepreneurship, a dramatic economic transition is occurring in what has become known as the Asian Crescent. Economic growth in Japan and countries such as Taiwan and South Korea and cities such Hong Kong and Singapore has been astounding during the past decade. There is a lesson here for the United States. Noel Barber observes in the _Singapore Story_:

> It is a success achieved despite tremendous odds stacked against it. The island has no resources—no food, no space, no raw materials—nothing but people. Yet the inhabitants of today's Singapore have taken part in an economic miracle that has staggered the world. They enjoy the highest per capita income in Asia after Japan; their

> economic growth is the envy of many a western nation; the city has become the fourth largest port; the country has no unemployment. It is unsullied by corruption; it has little or no drug problem; its crime decreases year by year.

These countries recognized true wealth-creating processes, moved to establish the institutions necessary to initiate and sustain economic growth, and then adopted modern technology to improve efficiency. Melvyn Krauss, author of Development Without Aid, calls the economic growth in the Asian Crescent the "competitive growth state." In a free market system, individuals have freedom of choice, are encouraged to take initiative, and are rewarded under such conditions. The economy is "closely integrated with the international marketplace...tax rates are low and business is by and large unregulated," Krauss adds. Government intervention is described as moderate and being primarily concerned with increasing the size of the economic pie rather than with allocating a fixed amount of wealth. This institutional framework has been responsible for remarkable growth. Taiwan, Singapore, Korea, and Hong Kong have developed their economies not through govermental design, but through the market forces of comparative advantage. These countries tilled the soil, but who planted the seeds for economic growth?

Since MITI has failed market forces have directed the Japanese economy. The Japanese industrial base has undergone an economic metamorphosis, evolving from a rubber-textile-steel industrial base to the automobile-electronic phase and on to the frontiers of several high-tech markets, such as robotics. U.S. policy makers and labor leaders would do well to note that in the process of this transition, real wages during the last 20 years have tripled. As the Japanese economy evolved from labor- to capital-intensive production, it began "invest[ing] heavily in such neighboring countries as Taiwan, South Korea, Hong Kong, and Singapore"—where labor is abundant—by packing up many of their steel and textile mills and shipping them to their Asian neighbors.

Now Taiwan, South Korea, Hong Kong, and Singapore are also progressing from labor- to capital-intensive production. Korea for example, is now successfully manufacturing automobiles. Clearly, both the Japanese and their neighbors benefit from exchanges that increase the marginal product of labor.

Contrast the above with the entrenchment mentality taken by U.S. labor, business, and governmental representatives:

* Union leaders and collectivist Democrats have introduced bills in 24 states and at the federal level proposing that businesses be prevented from closing their plants and moving to new locations. In all but the short run, such restrictions would hurt the workers the bills are intended to help. When a firm is legally prevented from moving to a location where expenses are lower, it is at a disadvantage relative to firms in less costly regions. These firms undersell those "locked-in" by law and, hence, failure can be expected. Such laws also hurt the region, as new companies are reluctant to open plants in places from which they cannot escape. Despite these problems, two states (Maine and Wisconsin) and one city (Philadelphia) have passed such bills.

* Similar bills initiating more extensive protectionist measures and more restrictive import quotas are before Congress. Such protectionist coddling of businesses does not lead to recovery; rather, it encourages, breeds, and compounds unproductive behavior. For example, the U.S. government first began protecting the steel industry during the late 1960s by forcing the Japanese into an agreement that involved 'Voluntary" restrictions on its exports. In 1977, the Japanese accepted even more restrictions with pressure from President Carter. Since then, the annual capital expenditure growth in the American steel industry has fallen to a meager four percent. Rather than retooling and upgrading capital and technology during the breathing space

provided by the restrictions (as originally promised), the industry diversified into more promising areas. In 1979, for example, U.S. Steel sold 13 steel and fabricating plants while opting to build a shopping center near Pittsburgh, purchase the Marathon Oil Company for $6.4 billion, and construct a chemical plant in Texas. The scenario is frightenly similar in U.S. automobile manufacturing, consumer electronics, and the footwear, textile, and apparel industries.

* By March 1984, at least seven bills were before Congress proposing the resurrection of the Reconstruction Finance Corporation (RFC), a bureaucracy designed to pump billions of tax dollars into both sunrise and ailing industries. Such a "corporation," however, does not allow for the industrial transition necessary for long-term economic growth. Subsidizing dying industries did not lead to the tripling of Japanese wages and economic growth in the Asian Crescent. Those in charge of allocating RFC subsidies have no way to predetermine which allocations most significantly enhanced productivity. They lack both the information and incentives provided by the market. In the case of the RFC, RFC personnel predictably bent to the pressures of political concerns and narrow special interest groups.

If productivity is to be increased, we must allow our industrial base to evolve with natural market forces, rather than to adopt the entrenchment mentality advocated by industrial policy proponents. Fortunately for the Asian Crescent, MITI has failed. U.S. collectivist politicians, however, seek to replace the spontaneous order of the market process with a system frighteningly similar to MITI. One would hope we have the wisdom to avoid constructing such obstacles to economic growth.

Given that stupidity is not a survival characteristic in the political arena, why does support for an industrial policy exist? Like the tribal

chieftains whose power was temporarily enhanced by cargo cult activities, industrial policy advocates presumably feel that their welfare and that of their clientele will be improved by moving decision making away from the market and toward coercive allocation. That this outcome is negative-sum is of little consequence. While stupidity is not a survival trait in the political arena, neither is principle. Thus we should be especially grateful for any small set of principled politicians.

Let us propose at least a benchmark for evaluating industrial policy. While easy to state, it will be difficult to implement, requiring work in constitutional economics that must precede meaningful reform. Any policy that encourages a constituency for general efficiency is good policy. Clearly, a "supply-side" industrial policy—i.e., one that minimizes governmental involvement—is superior to the alternatives that are currently being propounded by the collectivists.

We face a choice between two industrial policies. The one more commonly advocated views government allocation as the key to a solution. In contrast, we believe that governmental distortions are the primary problem. *A* supply side industrial policy employs the engine of market prices—-condensed sets of information and incentives—to move resources to more highly productive uses. This is the industrial policy we should adopt as we approach the Bicentennial of the U.S. Constitution—the best recipe ever written for industrial policy.

The Political Economy Research Center is an unusual organization. Our research orientation and level of commitment provide PERC associates with an important opportunity to analyze and make recommendations on economic and natural resource issues in both the governmental and private sectors. Approximately 50 percent of our efforts have been devoted to natural resource economics and policy, while the balance of our work deals with taxation, regulation, entrepreneurship, economic history, and a sprinkling of other topics. To the best of our knowledge, we are the only research organization with this orientation.

Since its founding in 1980, the Center has maintained a principled commitment to the development of a society of free and responsible individuals in their relations with one another and their environment. On the basis of considerable study and research, we expect these values to be fostered by social and political organizations relying on private property rights, the rule of willing consent, and the market process. Although we are sensitive to the problems of market failure, we recognize that there is an analogous set of problems with governmental management.

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