

The theoretical rationale for industrial policy in the eu essay sample



**ASSIGN
BUSTER**

Industrial policy has an important part to play in the economics of the European Union. Before discussing the EU's approach to this issue, it is important to define what we mean by industrial policy. One of the broader definitions of industrial policy states that it “ embraces all acts and policies of the state in relation to industry. ” (Bayliss and El-Agraa, 1990) However, industrial policy is not merely concerned with only manufacturing sectors, for example, a policy to support a service activity, like a bank or a airline, qualifies as an industrial policy.

Therefore, a broad economic definition of industrial policy might be “ all acts and policies of the state to alter the allocation of resources between sectors. ” (V. Curzon Price, 2001) Clearly, there is a contrast between industrial policy and competition policy. Whereas competition policy is concerned with preventing firms engaging in uncompetitive practices (such as abusing market power by charging high prices), industrial policy encourages firms to do what they otherwise would not do. For example, if firms were left to their own wishes, many of them would not invest in research and development because of the extra costs they would incur.

However, industrial or technology policy would provide incentives, such as subsidies on research expenditure, to ensure that research and development does actually occur. It is clear that industrial and technology policy is primarily concerned with making firms behave so they contribute to the objectives of society. Whereas competition policy is static and is interested in private gain, industrial policy is more dynamic and concerned with social gain. Why do we need industrial policy? There are many theoretical reasons

given for its existence. Firstly, industrial policy is used to increase competitiveness.

By this, we mean increasing the competitiveness of the EU internationally, particularly against North America and South East Asia (i. e. with respect to “triadic” competition), as well as increasing competition at a lower level, between member states. Competition is considered to be a vital feature of economic systems by many economists, including Devine, who states, “international competitiveness has become a necessary condition for any modern, dynamic economy.” (P. Devine, 1996) It is therefore important to use industrial policy as a means of increasing competitiveness inside the EU, and of the EU as a whole.

Communities with competitive economies are said to benefit from a virtuous circle of cumulative causation, whereas those with uncompetitive economies suffer from a vicious circle. (P. Devine, 1996) There is a neoclassical rationale for the existence of industrial policy, as well as for competition policy, however, with industrial policy, the emphasis is built around market failure. Therefore, industrial policy is used to correct certain types of market failure. One of the main types of market failure that can be corrected is the existence of externalities.

If firms were left to their own devices, they would not undertake enough research and development. As a result, the level of research and development in an economy would be less than the socially desirable level.

The reason for this underinvestment in research and development is because, once knowledge is discovered, it is freely available for anyone to

use. This is referred to as the free rider problem. Hence, if a firm developed a new technology, competitors would be able to copy this technology without incurring the costs. A firm would only undertake an investment if it benefits itself.

As we know, research and development is an important ingredient of economic growth, and therefore creates huge positive externalities.

Therefore, incentives need to be provided to encourage firms to undertake research and development. This gives rise to two policies. The first of these is the patent system. Patents provide a temporary and exclusive right to exploit any knowledge created, so it remedies the free rider problem. The second is public funding. The government provides money for research undertaken by different agents, such as firms or universities.

These policies help correct for market failure caused by externalities. The second type of market failure we use industrial policy for is the existence of knowledge imperfections. This is more difficult to correct for through the market, instead we need institutions to be developed which help find a way of exchanging knowledge, that cannot be traded through markets. In essence, we need to encourage cooperation for inputs between competing agents such as firms or universities, whilst making sure there is still competition for outputs.

For example, the government could encourage two pharmaceutical companies to collaborate when inventing a drug, using financial means, however once the drug is produced, the two companies must compete.

Industrial policy again has a prominent role in this. There are several other

reasons behind the existence of industrial policy. One of these is the infant industry argument. Infant industries suffer a disadvantage, because they never achieve as low costs as established ones. Established industries have a first mover advantage.

New industries therefore need a start up subsidy, and then it will eventually grow to be competitive. The problem with this is in reality, many industries do not “grow up,” and picking an industry to subsidise is difficult, as it is hard to pick an industry which will turn into a “winner.” Industrial policy can also be used to encourage industrial agglomerations. Agglomerations can be highly successful, as shown by the performance of Silicon Valley in the US, in its field of computing and technology.

Agglomerations can mean firms have easier access to specialised inputs, labour, and services, all of which will benefit an industry’s performance. Domestic distortions provide another reason for the existence of industrial policy. In different regions, political and social constraints affect public policies. Industrial policy may be needed to offset any negative effects created by these public policies. For example, Europe’s expensive social welfare system, whose cost falls mainly on firms, means they may be discouraged from investing in research and development.

Industrial policy can be used to offset these negative side effects. As illustrated by the example above, there can sometimes be a clash between different policies. A policy initiated by the EU may have completely different objectives compared to a policy initiated by a member state. When considering industrial policy, it is important to consider the implications for

having policy initiated at both member state levels and on the EU as a whole, and realise how important it is to have policies at both levels. To see why we need policy at all levels, we need to look back on the main objectives of conducting industrial policy.

One of these is to increase cohesion between EU member states. The EU cannot be considered to be a sovereign union if there are wide disparities between regions. Indeed, despite the introduction of the Euro, many disparities exist between different countries in the EU. Germany GDP, for example, has grown by only 0.4% from a year ago, whereas Britain's has grown by 1.7%. Regional regeneration in areas which are in decline, therefore, is a vital part of EU policy. Industrial policy has an important role to play in this.

It can be used to reorganise declining industries. In the UK, heavy industries such as coal and steel have declined, leading to a waste of resources and depressed regions. Also, industrial policy can be used to promote high-tech industries. One of the non-tariff barriers between EU countries is the difference in technical standards. Standards can be harmonised across the EU by subsidising research and development, and encouraging collaborative research where standards are low. The extent to which aid is provided to disadvantaged areas is a matter of controversy.

Article 87 states “ any aid granted by a member state or through state resources in any form whatsoever which distorts competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between member states, be incompatible with the common

market. ” It is clear that domestic policies used to increase the competitiveness of domestic industries will not be tolerated in the EU. There have been many examples of Article 87 being violated, such as the cases concerning Rover and British Aerospace.

The British government provided funds to these companies, which the EU courts saw as a violation, and ordered the funds to be repaid. A member state’s industrial policies must not undermine the common market by distorting competition. A criteria is needed when deciding which projects aid is made available to. A project must be well planned, and involve a partnership between key actors in a region. The EU doesn’t provide all funds for regional projects, it only provides money additional to member state funds. To conclude, it is easy to see industrial policy has an important role to play in the European Community.

Economic theory provides many reasons why industrial policy should exist. It is important to try and consider how these policies will actually work in practice. For example, subsidising research and development for some firms may lead to these firms gaining monopoly power, which would in effect distort competition. Also, protecting infant industries does not always work if the industry never grows to be competitive. Theoretical reasoning for industrial policy must be combined with a consideration for what actually happens in the real world. Care must also be taken when initiating regional industrial policy.

Again, providing substantial funds for certain areas or sectors may have a detrimental effect on competition, which in itself is a paradox, as one of the

principal aims of industrial policy is to promote competition. However, regional policy is vital to conducting industrial policy as a whole across Europe. The following quote emphasise this point. “ In Europe industrial policy must be regional policy, inspired and created within the regions, but regional policy must be coherent as a whole, at the inter-regional level, and common desires across regions should be pursued collectively. ” (Cowling and Sugden, 1993)