

# A "SUPPLY-SIDE" INDUSTRIAL POLICY

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## Introduction

The American debate on industrial policy was first provoked by Hamilton's *Report on Manufactures* in 1791. At that time the debate focused on whether the federal government had the constitutional authority to grant the recommended bounties to manufacturers. Hamilton argued that Congress had the power to pronounce upon the objects that concern the general welfare and that these objects extended to "the general interests of learning, of agriculture, of manufacturing, and of commerce." Madison responded sharply that "The Federal Government had been hitherto limited to the specified powers, by the greatest champions for latitude in expounding those powers. If not only the means, but the objects are unlimited, the parchment had better be thrown into the fire at once."

Our subsequent history indicates that Hamilton lost this battle but won the war. The *Report on Manufactures* was shelved. Hamilton then set up a private firm to promote the emerging technologies of that time; that firm went broke. But the same issue was later resolved in favor of Hamilton's argument, when it was determined that Congress could set higher tariffs on specific goods to promote selected manufacturing industries. The progressive erosion of the limits of the enumerated powers is one of the more serious problems of our democracy. The saddest comment on the recent debate on industrial policy is that this fundamental constitutional issue is no longer raised.

For the moment I will not join the bipartisan chorus of economists in criticizing the most recent proposals for a national industrial policy. My views on this issue are summarized in the 1984 *Economic Report*. My present purpose, in contrast, is to outline the elements

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*Cato Journal*, Vol. 4, No. 2 (Fall 1984). Copyright © Cato Institute. All rights reserved. The author is a member of the President's Council of Economic Advisers. This paper is adapted from his luncheon talk at the Cato Institute's conference, "Planning America: Government or the Market?" (April 27, 1984).

of what might be called a “supply-side” industrial policy, something that a contemporary Jefferson or Madison might propose if either had gained the presidency following a period of extensive intervention by the federal government in the allocation of resources. The first focus of their attention, I suggest, would be on those existing interventions that are part of the problem. The second focus would be to exercise the clearly enumerated powers of the federal government to promote the general welfare. Jefferson interpreted the Constitution to limit the federal government to the “external and mutual relations only of these states.” It may be too late to restore that halcyon condition, but it is appropriate to evaluate changes in policy by that high standard.

### The Elements of a “Supply-Side” Industrial Policy

In a brief discussion, of course, I can only summarize the elements of a “supply-side” industrial policy. More information will be supplied on request, at least after the election.

#### *Monetary Policy*

Many of the problems cited in support of an industrial policy are macroeconomic problems. A resolution of these problems requires changes in macroeconomic policies, not increased sectoral interventions.

The conduct of monetary policy in the United States has been characterized by two biases: Monetary policy has been procyclical and, during the last 50 years, it has been inflationary. Both of these biases are especially damaging to the manufacturing industries. Cyclical variations have reduced the average capacity utilization rate and the debt share of total capital. And inflation has increased the effective tax rate on the income from capital, because depreciation allowances are not indexed. The Constitution grants Congress the clear authority “To coin money [and] regulate the value thereof . . .” Maybe it is time for Congress to set a feasible standard for the conduct of monetary policy and to hold the Federal Reserve Board accountable to meet this standard.

#### *Fiscal Policy*

The federal budget provides substantial subsidies—in the form of grants, loans, and differential tax treatment—to the agriculture, energy, housing, medical care, and transportation sectors. Since the large relative support of these sectors diverts resources from other uses, the aggregate manufacturing sector should be regarded as a

negatively targeted sector. Selected manufacturing industries receive some support only as a by-product of defense and space procurement and of export subsidies. In addition the large federal deficit reduces both the demand for capital goods and investment in all industries.

An activist industrial policy, as advocated by Hamilton's heirs, would grant manufacturing firms their own place at the trough, by providing subsidized loans to politically favored manufacturing firms and, presumably, by increasing the deficit by the same amount. A more attractive alternative, I suggest, is to reduce both the present bias against manufacturing and the deficit by reducing the subsidies to the other sectors, relying on the market to reallocate the available resources.

The deficit is a serious problem and it must be reduced. The primary economic consequence of the deficit is a reduction of U.S. investment, both here and abroad. For that reason it would be particularly counterproductive if the necessary deficit reduction package included an increase in the taxation of business investment. A "balance-down" strategy, followed by a progressive reduction of the remaining tax biases against business investment, is a more effective way to increase the capital stock in the manufacturing sector. Among the tax measures that should be considered are to move to an expensing standard for all business investment and to change the tax credit on incremental R&D expenditures to a lower credit based on expenditures above some fixed base.

### *Regulatory Policy*

American industry is faced by a very complex set of laws and regulations that restrict its competitiveness. These laws and regulations serve other purposes, but the increasing concern about the competitiveness of American industry suggests that they may not reflect the desired balance of interests. In some cases the problem is due to a failure to exercise the clear responsibility of the federal government regarding patents and copyrights.

Our antitrust laws merit a thorough review. In many cases these laws are based on a premise that high concentration is associated with high prices, a premise that is not consistent with the accumulating evidence. In some cases the enforcement of these laws has had the effect of protecting weak competitors at the expense of effective competition. More attention should be given to the role of product substitution, foreign supply, and general excess capacity in disciplining potential monopoly behavior.

The administration has undertaken a number of steps to address these issues. Recent legislation now allows banks to organize export

trading companies, and it exempts these companies from antitrust actions initiated by the government. A bill now before Congress would exempt joint ventures for R&D from treble damage suits, where such ventures comply with certain disclosure provisions. A review of the 1982 Merger Guidelines, reflecting the above concerns, is scheduled to be completed in June.

Several laws that restrict the relation between financial institutions and nonfinancial firms should also be reviewed. In the United States, almost alone among the major industrial nations, banks may not own equity in nonfinancial firms, a restriction that dates from a court ruling in 1865 based on the National Banking Act of 1864. The resulting arms-length relation between banks and nonfinancial firms has a number of adverse consequences. This restriction may have contributed to the lower debt share of the total capital of U.S. firms. And U.S. banks are precluded from serving the role of the informed representative of outside stockholders, a role that is critical to discipline the incumbent management of nonfinancial firms. Bank regulators have reason to be concerned about the overall portfolio of individual banks, but their concerns need not preclude some bank ownership of equity.

Another obscure law, dating from 1940, prohibits pension plan sponsors from structuring a compensation arrangement with plan managers that is a function of the performance of the plan portfolio. This law effectively prevents plan managers from serving as an effective discipline on incumbent management, even though pension plans now own about \$700 billion of corporate assets. The Securities and Exchange Commission will soon issue a new ruling that relaxes this restraint to some degree.

These and other laws have increased the security of corporate managers at the expense of the stockholder and the competitiveness of American industry. A rising concern about the more dramatic recent takeover efforts may lead to new regulations that would only exacerbate this problem. Some effort is needed to explain that the threat of takeover, however uncomfortable to incumbent managers, is an important part of the market process that induces corporate management to serve the interests of the larger community.

The array of health, safety, environment, and energy laws and regulations approved during the last 20 years also deserves review. These laws serve important public purposes, but the explicit zero-risk standards in some of these laws prevent any meaningful balance of the several affected interests. I am intrigued to understand how the several candidates for President Reagan's job would resolve their strong commitment to both clean air and smokestack industries, but

that is not a sufficient cause for giving them that opportunity. Someday soon, I hope, there will be a basis for discussing these issues without the rhetoric of a holy war.

### *Foreign Trade*

The recent trend of increasing trade restraints is also discouraging. Such restraints clearly reduce our national income, by restricting a sorting out of American industry on the basis of comparative advantage. In some cases, where relatively high-paid workers are protected, these restraints reduce total employment in the short run. This problem will not be resolved by legitimizing new trade restraints in the name of facilitating adjustment. The historical record of these restraints is that they are more likely to delay, rather than to smooth, adjustment to market conditions.

What is the alternative to accepting the present and probable future increase in the protection of specific industries? Experience since the Kennedy Round suggests the answer. Average tariffs were progressively reduced only because these tariff changes were automatic, gradual, comprehensive, and mutual. In recent years these automatic reductions in tariffs were more than offset by the selective extension of other restraints. The implication of this development is that average effective tariffs are likely to increase unless some new automatic and general process of reduction in trade restraints is approved. Measures that are now being considered by the administration include an acceleration of the remaining tariff reductions under the Tokyo Round, the establishment of free trade zones with selected nations, and a new trade round focused on the major types of nontariff barriers.

### *Property Rights*

Finally, market forces will not work effectively without well-defined property rights. Patents and copyrights are an important form of property rights, particularly in the high-technology fields that are a prime concern of industrial policy. Many people have argued that patent limitations have deterred investment in certain fields of high technology and have allowed foreign competitors to appropriate some benefits of domestic innovation. In particular, historical principles of patent and copyright law have limited the protections that could be provided to computer programs, semiconductor chip designs, and other embodiments of modern technology. Moreover, anomalies in the patent law have weakened the right of U.S. patent holders to restrict the importation and sale of products that are made abroad through patent-infringing processes.

Some progress has been made. Computer programs have been subject to copyright since 1980. Several bills now before Congress would address these issues. One would provide copyright-like protection to semiconductor chip design, another bill would prevent the importation of goods produced abroad by patent-infringing production processes, and a third bill would permit the private patenting of technologies that were developed in part under government contract. The administration has substantially improved the patent review process and is studying the general set of intellectual property laws to identify other ways by which such property rights may be extended and strengthened. Congress should now address these issues to fulfill its constitutional responsibility "To promote the Progress of Science and [the] Useful Arts . . . ."

### Conclusion

The nation is now faced by a choice between two industrial policies. One policy perceives government intervention as part of the solution, the other as part of the problem. One would substitute the *judgment of politicians and bureaucrats for that of private investors*; the other would extend and strengthen market processes. One would sustain the progressive erosion of the enumerated powers; the other would build on the clear constitutional responsibilities of the federal government. I welcome the national debate on this issue. My choice should be clear.