THE POLITICAL ECONOMY OF NATIONAL INDUSTRIAL POLICY

Thomas J. DiLorenzo

Introduction

The phrase "national industrial policy" (NIP) can be viewed as a euphemism for national economic planning and an expanded welfare state.[1] This can be seen by examining some of the NIP proposals, which include greater governmental control over credit allocation, government domination of plant-closing decisions, governmental promotion or penalization of "winning" and "losing" industries through selective tax and subsidy schemes, and legislatively enacted co-determination.[2] Although the volume and variety of NIP proposals is mind boggling, the current debate over national industrial policy centers on one basic issue: Does economic growth best proceed through the spontaneous forces of the market or the coercive powers of the state? In short, the debate over industrial policy concerns the basic role of government in a free society: Should the powers of the state be used to cultivate the market order or to supersede the market and replace planning by individuals with planning by government bureaucracies? According to Hayek (1978, p. 234), this and other disputes over economic planning really hinge upon whether

> it is better that the holder of coercive power should confine himself in general to creating conditions under which the knowledge and initiative of individuals are given the best scope so that *they* can

---

Cato Journal, Vol. 4, No. 2 (Fall 1984).

The author is Assistant Professor of Economics at George Mason University. He was awarded second prize in the 1984 Olive W. Garvey essay contest sponsored by the Mont Pelerin Society for an earlier version of this paper.

[1]Few NIP advocates voice a preference for comprehensive national economic planning in view of the debacles created by all previous attempts. Instead, they urge more of a "halfway house" between comprehensive economic planning and a free market economy. As shown below, such partial attempts are doomed to fail for the same reasons comprehensive planning has failed.

[2]For an overview of these proposals see McKenzie (1983).

> plan most successfully; or whether a rational utilization of our resources requires *central* direction and organization of all our activities according to some consciously constructed 'blueprint.'

This paper evaluates the current NIP proposals by first explaining the general economic consequences of the "protective state" that facilitates market exchange and economic efficiency, and the "redistributive state" that arbitrarily directs the organization of individual activity according to political criteria. It is shown how government promotes economic cooperation and prosperity when it is restricted to protecting private property rights and the freedom of exchange, and how the redistributive or "planning" role of government leads to economic conflict, stagnation, and a loss of individual liberty.

The adverse effects of government planning are illustrated by examining the consequences of the NIP proposal to extend greater governmental control over the allocation of credit. It is explained how NIP proponents are deluded by the fallacious assumption that politics is inherently "cooperative" whereas market behavior is conflictual, and is therefore the source of economic instability. This is followed by a discussion of how the current debate over industrial policy is part of an ongoing struggle by political forces to supersede the market economy.

Markets, Politics, and Economic Growth

The market is a process in which individuals voluntarily interact with one another in pursuit of their own interests. With appropriately designed institutions—such as well-defined, enforced, and respected property rights and freedom of contract, freedom of exchange, and the enforcement of contracts—self-interested behavior generates a spontaneous order. This order is chosen by no one, yet it tends to maximize the subjective values of all the market participants. Only in this sense can the market process be termed "efficient." The maximization of subjective values, as individuals perceive them, is the end result of the market process and cannot be defined or "maximized" by any outside observer. A market situation can be judged "efficient" to the extent that it allows individuals to exercise their preferences subject only to the principles of mutual agreement and noninterference with the equal rights of others. The determination of what is efficient by some third party, such as government, would require interpersonal utility comparisons that are arbitrary and meaningless. In the absence of an omniscient and benevolent despot, market efficiency can be defined only in terms of the extent to which existing institutions facilitate mutually advantageous trade, subjectively valued.

Voluntary trade is a positive-sum game that increases the wealth of nations *as long as rights are exclusive.* That is, as long as property rights are defined, enforced, and transferable, productive activity will take place. If, by contrast, rights are attenuated, less trade and productive activity will take place. This amplifies the importance of one role that government has played in the economic system: the definition and enforcement of property rights. By establishing and enforcing the "rules of the game," government can encourage market efficiency and productive activity.

Of crucial importance is the protection of a well-functioning price system, for it provides the information individuals need to coordinate their plans and to engage in trade. Through the process of competition the price system reveals information on changing consumer preferences, changing relative scarcities, alternative levels of risk, and other information that is invaluable to decision makers, whether they are consumers or businessmen.

The fatal mistake of NIP proponents is that they ignore the fact that only through the competitive market process can we learn, via the price system, the relevant information for making economic decisions. To the extent that NIP proposals interfere with the price system (and they would), economic decision making and economic efficiency would be impaired. As Hayek stated (1978, p. 236):

> The chief reason why we cannot hope by central direction to achieve anything like the efficiency in the use of resources which the market makes possible is that the economic order of any large society rests on a utilization of the knowledge of particular circumstances widely dispersed among thousands or millions of individuals. . . . But among the alternative possibilities for coping with these difficulties—either conveying to a central directing authority all the relevant information possessed by the different individuals, or communicating to the separate individuals as much as possible of the information relevant for their decisions—we have discovered a solution for the second task only: the market and the competitive determination of prices have provided a procedure by which it is possible to convey to the individual managers of productive units as much information in condensed form as they need in order to fit their plans into the order of the rest of the system.

Furthermore, as an economy gains in size and complexity, it becomes even more necessary to rely on the market; for it is the only known mechanism that can effectively deal with such complexity. Subjecting private decision makers to further governmental interference through credit "controls," plant-closing boards, and other means can only increase uncertainty in the minds of entrepreneurs who must then refocus their efforts from serving consumers to dealing with red tape, directives, and regulations.

Thus, if economic growth is the objective, the most effective "industrial policy" would be for government to protect private property rights, safeguard freedom of trade and contract, and preserve the price system. In short, the proper role for government is to be the referee who watches over and enforces these rules of the game.

Politicial Resource Allocation

In recent decades the government's role has shifted away from being a referee to actively rearranging and redistributing property rights. In modern politics, ownership rights are not well respected. The state seems to operate with the notion that those within government can lay claim to all property rights and have the power to rearrange these rights arbitrarily through legislation. As individuals, politicians and bureaucrats are no different than the rest of us: They too prefer more rights to the use of resources to less and seek to maximize their utility. The utility of the politician or bureaucrat, however, is not enhanced primarily by acquiring ownership rights in goods and services through market activity. Politicians and bureaucrats gain access to goods and services by using their positions in government to bestow special privileges—to rearrange property rights—in favor of politically active individuals or groups. They do this in exchange for votes, campaign contributions, and other forms of political support. And they can do so at little cost; for those whose rights are consequently abridged are usually not politically well organized. In essence, the attenuation of property rights is the business of modern politics, and always has been. Politicians are continually seeking to expand the market for their services. Stability in private property rights is anathema to them because it imposes constraints on their abilities to accumulate power and wealth. Bernard Siegan (1980) has shown that since the early 1940s, there has been a progressive attenuation of property rights in the United States. The Supreme Court has failed, in effect, to protect our economic liberties by letting the legislative branch redistribute property almost at will.

The net effect of political resource allocation is to inhibit trade and production by reducing the expected benefits (for example, by restricting land use) and by increasing the costs. As more rights and resources come under political control, the returns to lobbying and other forms of political activity increase. This reduces the nation's productive capacity even further, because many of the resources spent by individuals and groups who seek special interest legislation are necessarily withdrawn from the process of production. Thus, by defining and enforcing property rights the state encourages productive activity, whereas by redefining and reallocating rights and interfering with the price system the state discourages production and encourages rent-seeking behavior.[3]

The importance of the government's role in protecting rather than rearranging property rights has long been recognized. Over 100 years ago Frédéric Bastiat wrote that governmental attempts to redistribute income will create "a frightful uncertainty . . . over the whole domain of private activity" (1964, p. 127). The value of individual responsibility, said Bastiat (1860, p. 10), will then be rendered

> more and more inert and inefficacious. By an improper application of the public force [to redistribute income], we alter the relation of labour to its remuneration, we disturb the laws of industry and of exchange . . . we give wrong direction to capital and labour. . . .

Bastiat (1964, p. 128) feared that once it is accepted among citizens that it is "legitimate" for government to arbitrarily redistribute income,

> we shall see the entire people transformed into petitioners. Landed property, agriculture, industry, commerce, shipping, industrial companies, all will bestir themselves to claim favors from the state. The public treasury will be literally pillaged.[4]

In sum, the NIP proposals, by expanding the domain of rent-seeking behavior, are inherently biased toward stifling, not stimulating, economic growth. As economic growth takes place over time, circumstances constantly change; and the market system best facilitates adaptation to change. Since it is precisely this adaptation that NIP proposals will delay or eliminate, they will stifle the source of long-term economic growth only for the short-term benefit of a few powerful special interests, including various businesses, unions, and other groups. As Hayek (1979, p. 94) recently noted, the social benefits of competitive markets and economic growth "are the results of such changes, and will be maintained only if the changes are allowed to continue." But every change hurts some organized interests; thus the preservation of the market order hinges upon our ability to stop these interests from preventing, through government, changes they do not like. Perhaps the major NIP proposal is for an expanded role of government in the allocation of capital. This practice provides a clear example of how allocating resources through politics rather

[3]Tollison (1982) provides a survey of the rent-seeking literature. Olson's (1982) work includes empirical estimates of the effects of rent-seeking behavior on economic growth.
[4]See Dorn (1981) for a fuller discussion of Bastiat's ideas on the role of government.

than markets benefits only a few at great expense to the rest of the nation.

The Political Economy of Government Credit Allocation

One of the most common themes of NIP enthusiasts is that there is an alleged need to "reindustrialize America . . . through a new partnership between government, management and labor" (Kirkland 1982, p. 20). That is, the market should be replaced by a "panel of experts," including businessmen, politicians, and union leaders. Lane Kirkland (1982, p. 20), president of the AFL-CIO, holds a view that all NIP proponents seem to share. He proposes

> the creation of a tripartite National Reindustrialization Board—including representatives of labor, business, and government—which would . . . insure the revitalization of the nation's sick industries and decaying communities, while at the same time encouraging the development of new industries with promise for the future. . . . This board would also direct the activities of a financing agency, patterned after the Reconstruction Finance Corporation of the 1930s and 1940s, which would be authorized to make and guarantee loans to finance approved reindustrialization ventures.

Proponents of a new Reconstruction Finance Corporation (RFC) claim benefits that such a program could not possibly produce. Supposedly an RFC is needed to better pursue "the longer-term perspective of the needs and aspirations of the American people" and to "target industrial sectors and regions that particularly need help" (Kirkland 1982, p. 21). It is impossible, however, for a government "planner" to obtain results that are superior (or even similar) to what an unregulated market economy can produce. Resource allocation by a resurrected RFC would subvert the role of the price system in allocating resources to their highest-valued uses, a role which, ironically, RFC proponents claim to be one of their chief objectives.

The idea that an RFC can improve the allocation of resources by "targeting" certain industries is absurd, regardless of the good intentions of its proponents. For this to be feasible, one must assume that government bureaucrats would be consistently better at forecasting consumer demands than are private firms and therefore will make better use of information (on behalf of consumers) than will private entrepreneurs. This argument is inherently flawed. In the private sector those firms that fail to accurately anticipate or forecast changes in consumer demands will not prosper and may not survive. Only firms that can best anticipate consumer demands and channel resources accordingly will survive in the marketplace. Those individuals and firms that have all the detailed knowledge of particular industries—knowledge of consumer tastes, the likely success of various technological advances, changes in relative scarcities of raw materials, and so on—are best able to "plan" for the future. By contrast, government bureaucrats are subject to no such forces. Failure to correctly and consistently forecast consumer demands is not met with "losses," for there are no profits or losses, in an accounting sense, in the public sector. Moreover, the bureaucrat often judges failure as success, because this provides him with opportunity to make a plea for even more funding for his bureau.

Government bureaucrats, by definition, are detached from the everyday workings of an industry and simply cannot plan as effectively as can private individuals or firms. They are not in a position to obtain all the "information of time and place" that is necessary to operate successful business enterprises (namely, ones that satisfy consumers), even if they had an incentive to do so. It is odd that in light of the well-documented failure of government bureaucracies to plan their own affairs efficiently, NIP proponents are attempting to convince the public that additional governmental control over *private* enterprise is desirable. Moreover, only the competitive market process can reveal the appropriate information in the first place.

An RFC would also subvert the very important role credit markets play in allocating risk. Credit markets evaluate the riskiness of alternative projects, and those with higher probabilities of failure (to meet consumer demands) are charged higher borrowing costs. In this way the credit markets give consumers and producers invaluable information about the most productive uses of resources. By socializing risk an RFC would make it impossible for consumers and producers to make truly accurate benefit-cost calculations; and resources are put to lower-valued, not higher-valued, uses once politics is used to allocate credit. For example, at times when high interest rates force private firms to invest in only the most productive projects promising very high yields, politically favored firms and industries would invest in projects yielding only a fraction of the return of the "unfavored" investments. Thus, by subsidizing economically inefficient but politically popular investments, an RFC would surely reduce the productivity of the nation's capital stock, thereby *lowering* the rate of economic growth.

In sum, by interfering with the market allocation of credit, governmentally controlled credit allocation would be very harmful to the nation's economy, even though it may confer short-lived benefits on politically favored industries, unions, and regions.

Political Versus Market Allocation of Capital

The establishment of an RFC is directly at odds with the growth-facilitating forces of the price system and, therefore, with consumer sovereignty. The whole purpose of an RFC is to prevent the price system from allocating resources and, instead, to assign that task to selected politicians, bureaucrats, businessmen, and union leaders. The creation of an RFC would convey the message that consumers are no longer to be trusted to register their true preferences via the price system. Rather, government bureaucrats would inform us what our preferences are and then "target" governmentally controlled credit into those areas. But even if government authorities were omniscient and could read the consumers' minds, there is no reason to believe that resources would be used efficiently. Equity, however defined, is equally unlikely, and political resource allocation often generates greater inequities than does the market. How politicians allocate resources under their control will depend on their perceptions of the personal benefits, such as votes and campaign contributions, that accrue from alternative allocations. As James Buchanan observed (1977, p. 13):

> Politicians are politicians because they want to be. They are no more robots than other men. Yet the politician who would do nothing other than reflect the preferences of his constituents would, in fact, be robotlike in his behavior. Few, if any, politicians are so restricted. They seek office because they seek 'profit' in the form of 'political income' which will normally be obtained only if their behavior is not fully in accord with the desires of electoral majorities. Those men who are attracted to politics as a profession are likely to be precisely those who have considerable interest in promoting their own version of good government, along with those who see the opportunities for direct and indirect bribes, and those who evaluate political office as a means toward other ends.

And as Senator William Proxmire stated during the July 25, 1983, Senate debates on industrial policy:

> Money will go where the political power is. . . . It will go where the union power is mobilized. It will go where the campaign contributors want it to go. It will go where the mayors and governors as well as congressmen and senators have the power to push it. Anyone who thinks government funds will be allocated to firms according to merit has not lived or served in Washington very long.[5]

Thus, an RFC can be expected to allocate credit in a way that is the most profitable politically: It will reward the most politically

[5]Cited in Poole (1983, p. 6).

active unions, industries, and regions. Such a strategy will promote "reindustrialization" only by accident. It can be expected to stifle economic growth by subsidizing economically inefficient but politically popular firms and industries.

The role of the federal government in allocating credit did not end with the original RFC in the mid–1950s. The RFC was just one among many tools used by federal politicians to control the allocation of credit during the Great Depression, and many of its remnants are alive and well. A survey of some of these practices will help in understanding the consequences of political credit allocation.

Loan Guarantees and the Allocation of Credit

Proponents of a new RFC rarely mention that in addition to about $30 billion in direct loans, there are already more than 150 federal loan guarantee programs administered by federal agencies that guide the allocation of more than $100 billion in loans annually.[6] Loan guarantees are part of the legacy of the original RFC, and expanded guarantees are an integral part of the more recent proposals.

The costs of federal loan guarantee programs, like the benefits, are indirect. A major difference, however, is that the benefits accrue to well-organized interest groups but the costs are widely dispersed among the general public. The predominant indirect cost of federal loan guarantees is borne by less-favored borrowers who are crowded out of the credit market or who must pay higher interest rates on the loans that are obtained. Loan guarantees tend to increase the overall demand for credit while at the same time reducing the supply of credit available to nonguaranteed borrowers. The effect is to increase the rates charged to nonguaranteed borrowers to levels higher than they would otherwise be, which crowds out much private borrowing. This seriously distorts the market process whereby unregulated markets allocate credit to its most highly valued uses, enhancing economic growth.

As an example of how private-sector investments are crowded out in favor of government-sponsored investments, consider the following: In 1980, when a 20 percent prime rate and a 16 percent consumer loan rate contributed to the bankruptcy of thousands of small businesses, such as auto dealerships and grocery stores, the Rural Electrification Administration began a new program to provide 35–year loans at 5 percent interest to finance rural cable television systems; rural home mortgages were available at 3.3 percent; and insured student loans went for 7 percent. Also during that year, while many

[6]The following discussion is based on Bennett and DiLorenzo (1983).

private utilities were paying 16 percent on their long-term bonds, the Tennessee Valley Authority (TVA) was borrowing at a rate that was several percentage points lower. As a result of this and other subsidies, the cost of electricity supplied by TVA is lower than it is in many areas served by less-favored private companies. In 1979, for example, TVA rates were about 50 percent lower than rates in such "frostbelt" states as New York and Massachusetts and about 38 percent below the national average.

It is very difficult, if not impossible, to gauge the extent of crowding out caused by federal loan guarantees, but some preliminary estimates have been made. Economist Herbert M. Kaufman of the University of Arizona conducted an empirical study of federal loan guarantees, in which he estimated that for every $1 billion in loan guarantees, between $736 million and $1.2 billion in private investment is crowded out. These are rough estimates, but they indicate that loan guarantees, which are being extended at a rate of over $100 billion per year, are certain to have a profound, negative impact on economic growth, employment, and price stability.

The federal government uses loan guarantees in a more subtle way to control the allocation of resources by influencing the recipients. For example the Federal Housing Administration (FHA), which administers the largest loan guarantee program, attempts to implement various social policies by vetoing a loan application if a builder does not comply with FHA's regulations regarding marketing to minority groups, environmental impact statements, architectural review, underwriting minimum wages, and so on. Because of the division of responsibility for these objectives, there is considerable confusion and delay, which increases the cost of housing construction. Further, once a firm or an industry is dependent upon financial assistance from the government, the dependence is often used as a lever to impose additional regulatory controls that may be totally unrelated to the government's contingent liability.

Equity Aspects of Federal Loan Guarantees

In addition to fostering a less efficient allocation of resources and hindering economic growth, many of the loan guarantee programs would be considered by many to be inequitable. An extreme case is the student loan program that, with few eligibility requirements, creates generous subsidies for higher-income households. With such loans available to students and their parents at a 7 percent interest rate regardless of income, the high market interest rates of the late 1970s and early 1980s provided many lucrative investment opportunities for wealthy families. As the spread widened between interest rates on student loans and market rates, new student loans rose from \$2.7 billion in 1979 to \$7.2 billion in 1981, reflecting the growing recognition of the opportunities to borrow thousands of dollars at 7 percent interest and invest the proceeds in long-term bonds or money market funds paying 14 to 16 percent. Futhermore, hundreds of millions of dollars in student loans are now in default, rendering these loans outright gifts to the students and their parents.

Regardless of the rhetoric associated with such programs, the vast majority of federal loan guarantee programs provide subsidies to individuals who are not generally considered to be financially disadvantaged. There is a very strong incentive for the administrators of loan guarantee programs to subsidize politically powerful groups, regardless of income, who will, in return, provide support for the agency at appropriations time. Even though the chief goals of the Department of Housing and Urban Development (HUD) are supposedly "the elimination of substandard and inadequate housing through the clearance of slums and blighted areas," it has established hundreds of programs that have nothing to do with slum clearance. For example, HUD's housing rehabilitation loan program has extended 3 percent guaranteed loans to individuals earning over \$50,000 per year to finance skylights and greenhouses.[7]

If there is a pattern of behavior that guides the granting of federal loan guarantees, it is based on the ability of the subsidized group to provide political support for the agency and its legislative sponsors, and not on efficiency or equity grounds. There is no reason to believe that a new RFC would behave any differently. Additional loan guarantees are an integral part of the current proposals for a resurrected RFC and would undoubtedly inflict further harm on the economy.

NIP enthusiasts apparently believe that the original RFC was a success, for its resurrection is the main plank in their industrial policy platform. A closer look at Hoover's original invention, however, indicates otherwise.

Hoover's Reconstruction Finance Corporation

Contrary to popular belief, the original RFC was not a product of Franklin Roosevelt's "New Deal" but was an offspring of Herbert Hoover's administration. After over a year of intensive lobbying, Hoover signed the RFC into law on January 11, 1932. Also contrary to popular belief, the RFC was a dismal failure that most assuredly made the Depression worse. Even though tens of billions of dollars were spent, unemployment stood at 9 million in 1939 and increased

[7]See Lambro (1980) for dozens of similar examples.

to the level reached in 1932 as the United States entered World War II.[8] This is hardly evidence of the alleged success of the RFC, and should come as no surprise, for the sole purpose of the RFC was to make unsound investments; that is, those that had been shunned by private capital markets. For this reason the RFC also severely reduced consumer welfare during the Depression years. That a private business venture is unable to obtain credit is evidence that the venture is not likely to satisfy consumer demands as well as alternative uses of that credit. Therefore, the private capital markets channel those funds into uses that would better serve consumers. Thus, the effect of the RFC was to *reduce* economic growth *and* to replace consumer demand with the preferences of politicians and bureaucrats.

The RFC could not possibly have aided economic recovery during the Depression, nor could it do so today. It only served to delay the market adjustments that are necessary to attain economic recovery. During an economic downturn, market forces work to channel resources into their most productive uses, enhancing economic growth and spurring a recovery. Subsidizing less productive resources through the aegis of the RFC only delayed or aborted the recovery.

The true character of the RFC was revealed during congressional floor debates on the RFC bill in 1931. There was little pretense that the bill was anything but a means of subsidizing economically inefficient but politically popular businesses. As historian James Olson stated (1977, p. 112):

> The response of businessmen to the bill was so overwhelmingly positive that Congressmen were immediately suspicious. Representatives of commercial banks, railroads, savings banks, building and loan associations, and life insurance companies all praised the bill in glowing terms. [T]heir commitment to the bill was absolute.

Several congressmen harshly criticized the bill. Representative Fiorello LaGuardia of New York, for example, called the bill

> a millionare's dole and you cannot get away from it. It is a subsidy for broken bankers—a subsidy for bankrupt railroads—a reward for speculation and unscrupulous bond pluggers.[9]

Representative Louis McFadden of Pennsylvania was even more critical, calling the bill a scheme by "financial criminals" for

> gouging $500,000,000 out of the Treasury of the United States. It is a scheme for taking $500,000,000 of the people's money produced by labor at a cost of toil and suffering and giving it to a supercorporation

[8]Cited in Rothbard (1972).

[9]*Congressional Record*, 11 January 1932, p. 1742.

> for the sinister purpose of helping a gang of financial looters to cover up their tracks.[10]

As long as it was in their self-interest to do so, these and other congressmen "spoke their minds" about the RFC and what it was designed to accomplish. But attitudes changed as soon as President Hoover showed them how it could work to their own political advantage. For example, Arkansas Senator Joseph Robinson's objections were eliminated by the promise to grant loans to livestock and agricultural credit corporations, to federal land banks, and to joint stock land banks (Olson 1977, p. 38). Senator Ellision ("Cotton Ed") Smith of South Carolina became a true believer because of a promise to grant $50 million to the Secretary of Agriculture for small crop loans. Other congressmen were similarly convinced of the so-called merits of the RFC when Hoover asked *them* to select the members of the RFC's board of directors. Thus it was that a process of arm twisting and logrolling produced the RFC in January 1932, despite earlier protests. Hoover then praised the "patriotism of the men of both houses of Congress who have given proof of their devotion to the welfare of their country, irrespective of political affiliation."[11]

The RFC act provided for massive government intervention in the economy by extending loans and loan guarantees to such enterprises as banks, insurance companies, trust companies, building and loan associations, mortgage companies, credit unions, federal land banks, agricultural credit corporations, livestock credit companies, railroads, and, eventually, even topless bars and massage parlors.[12]

As with the proposals for a new RFC, the original RFC's board of directors included businessmen, bankers, and bureaucrats. It is no surprise, therefore, that big business, big banks, and government bureaucracies were the major beneficiaries of the RFC, all at the expense of the American taxpayer, who was subjected to one of the largest tax increases in history (up to that time) in 1932. The large tax increases of 1932 surely stifled private economic activity even further, thereby deepening the Depression.

Once the RFC began its operations in early 1932 it attempted to make every individual, group, and industry a "preferred borrower," as each congressman scrambled to ensure that his constituents would receive their share of the largesse. Jesse H. Jones, director of the RFC from 1932 to 1945, wrote a book boasting about how he spent

[10]*Congressional Record*, 11 January 1932, p. 1924.

[11]*Congressional Record*, 11 January 1932, p. 1705.

[12]For a history and analysis of the loans made by the original RFC, see Denzau and Hardin (1984).

$50 billion of taxpayers' funds during that time "with almost unlimited authority" (Jones 1951, p. 3). The enormous scope of government intervention in the credit markets is revealed in the volume by Jones, and is exemplified by such statements as, "we even loaned money on a drove of reindeer in Alaska," and "when the grape growers of California felt the pinch of hard times, they, like almost everyone else, hollered for help in Washington" (1951, p. 183).

The RFC bailed out thousands of failing businesses and, by law, it was designed to do exactly that. As Jones stated, "The law specified that we should lend only where the borrower could not get the money from others on reasonable terms" (1951, p. 183). Thus, the RFC was to make only inefficient investments, those that would reduce both economic growth and consumer welfare. It was merely a tool Jones and his political allies used to forcefully impose their preferences on the general public at the great expense of intensifying the Depression. That RFC bureaucrats were among the chief beneficiaries of the RFC's operations is indicated in Appendix IV of Jones's book, "Some RFC Alumni Who Have Done Well," which reads like a "who's who" of the Fortune 500. For example, the first page of the appendix lists former RFC loan executives, auditors, and attorneys who, after they left the RFC, attained such positions as vice president of Greenwich Savings Bank, general solicitor of the Baltimore and Ohio Railroad, and various bank presidencies. For these individuals, working at the RFC was an investment in human capital, a time spent feathering the nests of banks and businesses (at taxpayers' expense) in return for future employment opportunities with those businesses. Other researchers (Eckert 1981) have found this to be a general consequence of government regulation of industry. Regardless of the "public interest" rhetoric, much regulation merely serves to benefit regulators and various regulated industries, not the general public, and the RFC was no exception. It is easy to understand why so many bankers, businessmen, union leaders, and politicians have chosen to ignore history and reality by making appeals for a new RFC.

In summary, government control of credit allocation is inherently incompatible with economic growth. The argument that if only done "right," government bureaucracies can outperform private markets is nonsense that simply should not be countenanced. Moreover, arguments that greater government involvement is essential for reasons of "fairness" or "social justice" are equally unfathomable. In a free market economy, those who make the best use of resources are those who can best serve others in the society. Those who offer consumers the best products at the lowest prices will be "targeted" by the capital markets. Politics can only obstruct this process by arbitrarily redirecting resources to politically popular but economically inefficient uses, and at great expense to consumers. The loss of individual freedom is heightened by this process, for individuals are encouraged to put less effort into pleasing others in the society (that is, consumers) and more toward catering to the whims of the political authorities.

Cooperation and Conflict: The Industrial Policy Delusion

A basic premise of most, if not all, of the NIP proposals is that the problem of slow economic growth is best addressed through "cooperation," most notably between "government, labor, and business," an arbitrarily chosen collection of special interests. The political process is said to embody a spirit of cooperation among businessmen, union leaders, and politicians that will help solve the nation's problems (as though nations, not individuals, have problems). However, there are two basic misconceptions here. First is the age-old myth that collective, as opposed to individual, decisions are made for the "public interest," in a spirit of selflessness or concern for others. "Good" motivation is thought to lead to "good" results. By contrast, "bad" motivation (for example, self interest and the profit motive) leads to "bad" results. In other words economic problems are often caused by perverse individual behavior, but they can be corrected by a sufficiently benevolent group of enlightened statesmen. Clearly, we do not observe this type of schizophrenic behavior: There is no logical basis for believing that individuals are any more or less self-interested when they make collective decisions than they are when making individual decisions. No divine transformation takes place when individuals leave the private sector for the public sector; nor do halos turn to horns when the opposite occurs.

This has given rise to the second major misconception, a confusion over the meaning of "cooperation" in market as opposed to nonmarket (that is, political) settings. As stated earlier, the market is essentially a process through which individuals, acting in their own interests, cooperate to get what they want, subject only to the principle of mutual agreement. Adam Smith's well-worn dictum is as trite as it is true: It is not the benevolence of the butcher or baker that provides us with our meat and our bread, but concern for their self-interest.

By contrast, *political* cooperation is inherently conflictual, for political "exchange" is necessarily zero-sum, at best. In politics, one party or coalition can gain *only at the expense of others* through a rearrangement of property rights. This will always be true in the absence of a voting rule of unanimity. The coercive powers of the state are used to enforce such changes, which are the source of much social conflict. Market exchange, since it is voluntary, is necessarily positive-sum or "unanimous," benefiting *all* parties involved.

Recent events in the transportation industry illustrate what can be expected from "cooperation" in politics. It is well known that in the trucking industry, for example, business, labor, and government have cooperated and the Interstate Commerce Commission was part of an earlier industrial policy aimed at fostering such cooperation. With the aid of the coercive powers of government, trucking firms and the Teamsters union were able to cartelize the trucking industry, thereby redistributing wealth from the general population to themselves. Politicians gladly cooperated, for they shared in the government-sanctioned monopoly profits in the form of votes, campaign contributions, and other means of political support. Strong taxpayer support for deregulation of the trucking industry is evidence that taxpayers do not find this particular industrial policy to be in their best interest. This, however, is precisely the type of cooperation NIP enthusiasts urge upon us.

Business, government, and unions can also be expected to cooperate on the issue of protectionism. The notion that businesses and unions are generally adversaries who deal with each other on an "arms length" basis is becoming increasingly untenable. This is so because in many areas businesses and unions cooperate or conspire to secure common objectives, such as protection from international competition. In recent years U.S. automobile producers have joined forces with the United Auto Workers to lobby for import quotas, "domestic content" legislation to require foreign cars to be constructed in the United States, and other forms of protectionism. And they have been quite successful; the Reagan administration has succumbed to protectionist pressures in the automobile, steel, textiles, motorcycle, and even clothespin industries, to name a few.

In sum, because government is the chief agent of coercion in society, it is misleading, at best, to suggest that political cooperation will lead to such lofty goals as "economic progress" or "social justice." A coalition of business, labor, and government is more likely to conspire against the general public than cooperate to serve it. In contrast, since free trade is voluntary, no individual or group can coerce or exploit another in market exchange. It is in every individual's self-interest to cooperate with others (most of whom he does not know) by trying to produce what they want. By doing so the welfare of society as a whole is enhanced. If one wishes to stress the importance of cooperation in economic affairs, the appropriate emphasis should be on *market* exchange or cooperation, not political cooperation. The former tends to increase the wealth of nations, whereas the latter is a major source of economic stagnation.

The Industrial Policy Cycle

In essence the NIP proposals are nothing other than a thinly disguised plea for an expanded welfare state and some version of national economic planning. It is sufficiently clear, however, that these policies are the root causes of economic stagnation. In recent decades government intervention has severely stifled productivity in the United States and elsewhere largely because of accelerated inflation, high taxes (and tax rates), price controls, and other regulations (Kendrick 1981). All of these government policies stifle individual incentives to work, save, and invest, which are the ingredients of economic growth. These policies also increase the power and prestige of politicians, bureaucrats, and other supporters of the welfare state and governmental planning. This is why, despite overwhelming evidence accumulated ever since Adam Smith exposed the fallacies of mercantilism, there are renewed pleas for even greater government intervention. When NIP proponents simply ignore all the lessons of history and economic theory, they participate in a con game that must be exposed.

It has often been said that in government, "failure is success." That is, when government policies cause economic instability there is inevitably a public demand for the government to "do something" about it. It is the natural proclivity of politicians to avoid admitting that their own actions caused the problems in the first place and to undo their mistakes. Instead, they typically offer new programs and policies to "solve" the problems. The end result is even more economic instability, and even greater power placed in the hands of the political authorities. The current industrial policy hype is part of this cycle and is largely a political response to the failed governmental policies of the 1960s and 1970s.

NIP proponents have distorted the facts about the U.S. economy. Government intervention is clearly the cause of, not the cure for, our economic problems. NIP enthusiasts have also reversed reality when they cite the Japanese economy as a successful prototype of their brand of industrial policy. If one considers the *facts,* the Japanese experience provides an invaluable lesson for the United States and the rest of the world, but the lesion is not that an interventionist industrial policy works. Dr. Katsuro Sakoh (1983) conducted an extensive empirical study of the relatively prosperous Japanese economy of the early 1970s and concluded that Japan's success was the result of

> [a] basically free market economy, functioning effectively with minimal government intervention. The collapse of Japan's traditional feudal society in the 1940s and the emergence of a more open society triggered an explosion of creative energy. Free speech, human rights, and freedom of investment and pricing changed the country's political and economic dynamics. Any Japanese—regardless of age, class, or family background—could venture into business and succeed through hard work, imagination, willingness to take risks, and luck. Many dynamic and exciting new enterprises, such as Honda, Yamaha, Sony, and Suzuki, to name but a few, sprouted in this climate. In short, individual entrepreneurs did not invest in capital goods and equipment because MITI officials suggested it, but because these entrepreneurs glimpsed the potential for future profits by beating the competition in both domestic and foreign markets. The market mechanism allowed Japan's industrial structure to be transformed by the 1970s, as older industries were replaced by these new manufacturing industries.

The "Japanese miracle" has now apparently ended, as the Japanese economy became very sluggish beginning in the mid–1970s. It is no surprise that as this occurred, there was a marked increase in government intervention. In 1982 Japan experienced its first large quarterly drop in real GNP in 30 years, and economic growth during that year was only about a third of what it had been during the previous 25 years (Drucker 1982, p. 28). Furthermore, productivity growth has fallen even more steeply in Japan in recent years than in either the United States or Western Europe, and savings are only two-thirds of the average levels of the 1970s. The reasons for this little-publicized economic decline are not that Japan has abandoned what little efforts it had made at "industrial policy," but rather the familiar problems of uncontrolled government spending and rising federal deficits and regulation. As Drucker recently stated (1982, p. 28):

> Throughout its years of rapid economic growth, from the early 1950s to the mid 1970s, Japan's budget was balanced or in slight surplus. Japan shifted to deficit spending in 1975–76 and the economy promptly began to slow down. The deficit is now more than three times larger than seven years ago. It is larger, both per capita and as a proportion of GNP, than the deficit of any other highly industrialized country except Canada. And, just as in the highly developed countries of the West, government in Japan is now beginning

> to crowd private borrowers out of the capital markets. This is occurring just when Japan needs to make heavy investments in automation, in new technologies and in manufacturing subsidiaries abroad. . . .

The question that must be posed to those who advocate an interventionist industrial policy for the United States is: If such a policy is responsible for Japan's success, why has the Japanese economy stagnated during the past eight years (in many ways far more severely than the economies of either the United States and Western Europe)?

Conclusion

One positive aspect of the industrial policy debate is that it has refocused attention on the important issue of the role of government in a free society. One role of government is to protect private property, freedom of exchange, and freedom of contract. In short, the government's responsibility is to cultivate an institutional environment in which the spontaneous forces of the market can best coordinate individual plans so as to enhance individual welfare. Government, however, has strayed far from this role, and it now actively supersedes the forces of the market and is, therefore, the cause of many of our economic problems. Furthermore, the redistributive role of government is a major source of interpersonal conflict, despite the much-touted pleas for greater "cooperation" among politicians, businessmen, and union leaders. The industrial policy proposals would empower the government to expand its activities of favoring some groups at the expense of others in society, which violates the principles of justice and equality of treatment—principles that NIP proponents ironically claim to be their concern. Neomercantilism is perhaps a better name for an interventionist industrial policy. Adam Smith described what he thought was the immorality of such policies more than 200 years ago (1960, p. 152):

> To hurt in any degree the interest of any one order of citizens, for no other purpose but to promote that of some other, it is evidently contrary to that justice and equality of treatment which the sovereign owes to all the different orders of his subjects.

To invigorate industry and to pursue the principles of justice and equality of treatment requires reducing the size and scope of government, not expanding it. Accordingly, an appropriate industrial policy is one that reduces the burden of taxation, encourages privatization of government-run enterprises, eliminates regulatory restrictions on the freedom of exchange, and places strict limitations, perhaps constitutionally imposed, on the size and growth of government and on the destruction of wealth and welfare it inevitably entails.

References

Bastiat, Frédéric. *Harmonies of Political Economy*. Translated by Patrick James Stirling. London: John Murray, 1860.

Bastiat, Frédéric. "Justice and Fraternity." In *Selected Essays on Political Economy*, pp. 116–39. Translated by Seymour Cain and edited by George B. de Huszar. Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1964.

Bennett, James T., and DiLorenzo, Thomas J. *Underground Government: The Off-Budget Public Sector*. Washington, D.C.: Cato Institute, 1983.

Buchanan, James M. "Why Does Government Grow?" In *Budgets and Bureaucrats: The Sources of Government Growth*. Edited by Thomas Borcherding. Durham, N.C.: Duke University Press, 1977.

Denzau, Arthur T., and Hardin, Clifford M. *A National Development Bank: Ghost of the RFC Past*. St. Louis: Center for the Study of American Business, Washington University, 1984.

Dorn, James A. "Law and Liberty: A Comparison of Hayek and Bastiat." *Journal of Libertarian Studies* 5 (Fall 1981): 375–97.

Drucker, Peter F. "Clouds Forming Across the Japanese Sun." *Wall Street Journal*, 13 July 1982, p. 28.

Eckert, Ross. "The Life Cycle of Regulatory Commissioners." *Journal of Law and Economics* 24 (April 1981): 113–20.

Hayek, F[riedrich] A. *New Studies in Philosophy, Economics, and The History of Ideas*. Chicago: University of Chicago Press, 1978.

Hayek, Friedrich A. *Law, Legislation, and Liberty*, Vol. 3, *The Political Order of a Free People*. Chicago: University of Chicago Press, 1979.

Jones, Jesse. *Fifty Billion Dollars: My Thirteen Years With the Reconstruction Finance Corporation*. New York: Macmillan, 1951.

Kendrick, John W. "International Comparisons of Recent Productivity Trends." In *Issues in Contemporary Economic Problems*, pp. 125–70. Edited by William Fellner. Washington, D.C.: American Enterprise Institute, 1981.

Kirkland, Lane. "An Alternative to Reaganomics." *USA Today*, May 1982.

Lambro, Don. *Fat City: How Washington Wastes Your Taxes*. Southbend, Ind.: Regnery Gateway, Inc., 1980.

McKenzie, Richard B. "National Industrial Policy: An Overview of the Debate." Heritage Foundation *Backgrounder* No. 275, Washington, D.C., 12 July 1983.

Olson, James. *Herbert Hoover and the Reconstruction Finance Corporation*. Ames, Iowa: Iowa State University Press, 1977.

Olson, Mancur. *The Rise and Decline of Nations*. New Haven: Yale University Press, 1982.

Poole, Robert, Jr. "Healing American Industry" (editorial). *Reason* 15 (August 1983): 6.

Rothbard, Murray. *America's Great Depression*. Kansas City, Kans.: Sheed and Ward, 1972.

Sakoh, Katsuro. "Industrial Policy: The Super Myth of Japan's Super Success." Heritage Foundation, Asian Studies Center *Backgrounder* No. 3, Washington, D.C., 13 July 1983.

Siegan, Bernard H. *Economic Liberties and the Constitution.* Chicago: University of Chicago Press, 1980.

Smith, Adam. *The Wealth of Nations.* London: Cannon, 1960.

Tollison, Robert D. "Rent Seeking: A Survey." *Kylos* 35 (Winter 1982): 575–602.